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Comments of Calpine Corporation
On the California Air Resources Board's
Allowance Allocation Methodology
For a California Cap and Trade Program
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Calpine Corporation ("Calpine") appreciates the opportunity to provide input to the California Air Resources Board ("CARB") on its deliberations regarding the appropriate allocation of emission allowances for the electric sector under California's greenhouse gas cap and trade program. Calpine supports and appreciates the responsive direction staff is pursuing to implement AB 32, the California Global Warming Solutions Act of 2006, in light of the current economic conditions. Calpine offers these comments on the CARB Staff Presentation on Allowance Allocation presented at its workshop on May 17, 2010.

Calpine is a long-time advocate for low-carbon and renewable energy resources and, as the nation's first power producer to include a carbon limitation in a federal air permit, is a recognized leader in environmentally responsible power generation. In California, Calpine has 5,800 megawatts of operating electric generating capacity with another 600 megawatts in advanced development. As owner and operator of 725 megawatts of geothermal energy, Calpine is California's largest renewable energy provider and is a state leader in combined heat and power production. Since 2001, Calpine has invested more than $5 billion to add more than 4,000 megawatts of clean, efficient new generating capacity that is helping to retire polluting, aging and inefficient power plants.

In general, Calpine supports flexible, market-based solutions that will encourage a transition from more carbon-intensive generation to efficient, low carbon-intensive generation and renewable power within the energy sector. Calpine also supports the CARB's recommendation to move towards full auction of emissions allowances while still accommodating transitional issues that may cause economic harm or cause emission leakage.

Summary

Calpine's comments may be summarized as follows:

- Calpine strongly supports the CARB's goal to avoid significant economic gains or losses due to allowance allocation decisions and appreciates staff's

recognition that some entities do not have opportunities to recover greenhouse gas compliance costs and will thus suffer economic harm absent some type of allowance allocation or other transitional cost recovery mechanism.

- Calpine urges CARB to include provisions in the rules to hold harmless generators operating under existing long term contracts originally executed before the prospect of greenhouse gas regulation and that do not offer the generator a reasonable opportunity to recover carbon costs ("Pre-Cap and Trade Contracts").

Furthermore, if it continues on the path to allocate allowances to the load serving entities ("LSEs"), Calpine requests that the CARB be mindful in developing the appropriate regulations and oversight to ensure that the there is no competitive disadvantage to independent, merchant power producers who will not receive free allowances yet must compete against LSEs in the generation market.

Allowances should be allocated to generators that cannot recover costs.

In general, Calpine agrees with the CARB that the implementation of a centralized auction for regulated entities in the electric sector will provide an efficient mechanism for distributing allowances. However, this is only the case for those generating facilities that are able to recover their compliance costs, such as those entities that sell power at market-based rates or operate under recently-originated contracts that include provisions related to the allocation of allowance costs. Calpine urges the CARB to recognize that some independent power producers face unique circumstances in that they operate under Pre-Cap and Trade Contracts. Unlike most regulated entities, these generators remain subject to the terms of their existing Pre-Cap and Trade Contracts, and it is unlikely their counterparties would accept contract changes to allow cost recovery. Rather than providing constructive price signals related to carbon reduction strategies, imposing allowance costs on this group of generators would simply be punitive, since there would be no opportunity to recover such costs. This would create a notably unfair and discriminatory situation between power generators that operate under binding contracts – which pre-date the enactment AB32 – and all other generators in the market, which have an opportunity to recover such costs.

The types of electric generation facilities that may require free allowances in the early stages of a cap and trade program include state-of-the-art, environmentally preferred combined cycled natural gas facilities as well as combined heat and power (CHP or cogeneration) facilities which provide both steam and electricity to nearby industrial facilities. In either case, the underlying truth remains; for the energy and/or steam produced, the facility has no

opportunity to recover carbon costs and will thus suffer economic harm due to the creation of the cap and trade market.

It is important that the cap and trade system not disadvantage CHP. In developing its scoping plan, the CARB recognized that CHP typically has much lower CO2 emissions than conventional power generation and is therefore is an important part of California's efforts to reduce GHG emissions. In fact, the CARB's AB32 scoping plan relies on the assumption that the existing 3000 megawatts of existing CHP generation continues to operate. Without some provision to protect these facilities from the economic harm that may result from the lack of carbon cost recovery in these existing long term contracts, it may become impossible for all 3000 mw to remain financially sound and operational.

Calpine currently has 7 efficient, combined cycle and/or combined heat and power ("CHP") facilities in California that operate under such contracts. Each will suffer substantial economic harm without some mechanism for compliance cost recovery. Additionally, these generators support industrial facilities also vital to the California economy, such as a steel rolling plant that provides steel for cans and building materials, agricultural processing facilities, a state hospital and a water distillation facility. Just like it has proposed for similarly situated industrial sources, we urge CARB to provide for direct allocation of allowances to these electricity producers as a transitional measure or provide some other regulatory relief that does not penalize some of the more efficient generating facilities in the state.

Other national and regional cap and trade proposals and programs have provided either free allowances or set-asides for thermal and electrical power sales under long-term contracts. New York, New Jersey and the proposed Federal bills offered by Waxman-Markey (House) and Kerry-Lieberman (Senate) recognized the unique circumstances of generators who entered into long-term contracts either with industrial customers or load serving entities prior to the prospect of greenhouse gas regulation.

CARB can create a free allowance program for generators with existing long-term contracts that is administratively simple.

There are other ways to provide relief to generators with long term contracts but the most common is to establish a process whereby generators under long term contracts apply for free allowances for the portion of their power and/or thermal energy production obligated under existing long-term contracts or on-site consumption. The program or rule need not be complicated or unduly burdensome for the applicant or CARB. The program needs only to address two major areas of policy – eligibility and determination of allowance requirements.

1. *Eligibility* - The CARB's regulations should establish eligibility criteria which require the applicant to demonstrate to CARB's satisfaction that the applicant is unable to recover the cost of CO2 allowances under the conditions of its long term contract. The applicant should be willing to submit a copy of their respective contracts (subject to appropriate confidentiality protection for commercially-sensitive information) and an affidavit certifying that the long term contract applicant is unable to: a) pass the cost of allowances on to the purchasing party, or b) renegotiate the terms of the contract. Obviously, as these contracts expire and/or are replaced, the need for this free allowance program would diminish and would ultimately disappear.

2. *Determination of Allowance Requirements* – The CARB should also determine and verify the amount of allowances required by entities applying for such allowances. Applicants should be required to provide to CARB historical fuel use, total net output and emissions data and an estimate of the emissions related to contract sales versus any emission that might be related to merchant sales during the upcoming year, if applicable. For CHP facilities there should be a formula to apportion the overall facility output to determine the proportion of emissions from thermal energy production as well as electricity production that are under contract.

   In order to guarantee that the number of allowances granted by CARB match actual emissions, CARB could adopt certain true-up provisions. This is a mechanism by which applicants must reconcile actual versus estimated emissions during each subsequent application period. If utilized, such a program would require that excess LTC allowances would either be returned or credited in amount of the difference between actual emissions and the number of allowances granted. If an applicant under-estimates its needs it may request a commensurate number of additional LTC allowances in a subsequent application year.

   In addition, CARB could include regulations in this area to enforce that the means of cost recovery remain limited only to an eligible entity's verifiable emissions costs exposed under long term contracts. These regulations could include limitations on the ability to sell or transfer the allocations to any other party and/or limitations on the number of free allowances an entity could utilize.

CARB should ensure that cap and trade program rules do not favor utility owned generation over merchant generator owned facilities.

As communicated at the May 17 workshop, CARB intends to first allocate allowances to the load serving entities who will then auction allowances to regulated entities within the electric sector. As previously noted, Calpine generally agrees with the approach to auction allowances for the electric sector. However, Calpine shares the concerns of the Independent Energy Producers and the Western Power Trading Forum that directing free allowances to the LSEs is suboptimal and, therefore, adequate measures must be taken to ensure that independent power generators are not put at a disadvantage vis a vis their utility counterparts.

To protect the competitive nature of California's generation market, CARB should, at a minimum, require that the LSEs auction 100 percent of allocated allowances and restrict the use of any auction revenues from applying to LSE generation development or ownership costs. Furthermore, CARB should consider the use of a centralized auction pool for the auction of all the state's allowances rather than having separate auctions by each LSE in order to increase market transparency and ease of administration for regulated entities.

Conclusion

In summary, Calpine supports the CARB's policy objective to transition California's economy to the cap and trade market and urges the CARB to adopt a free allowance allocation program for electric generators operating under Pre-Cap and Trade Contracts. In addition, Calpine asks that the CARB develop its policies in such a way that it does not discriminate between LSE-owned and merchant owned generation and protects a competitive generation market.

Thank you for this opportunity to comment.

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