



# CALPINE CORPORATION

October 8, 2009

Dr. Lawrence Goulder, Chair  
Economic and Allocation Advisory Committee  
California Air Resources Board  
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Dear Dr. Goulder:

Calpine Corporation appreciates the opportunity to provide input to the Economic and Allocation Advisory Committee (the Committee) on its deliberations regarding the appropriate allocation of emission allowances under California's greenhouse gas cap and trade program.

Calpine is a long-time advocate for low-carbon and renewable energy resources and a recognized leader for environmentally responsible power generation. In California, Calpine has 5,200 megawatts of generating capacity in operation and approximately 1,200 megawatts of generation in construction or 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 alone, 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.

As an early supporter of AB 32, the California Global Warming Solutions Act of 2006, Calpine supports flexible, market-based solutions that will reward the transition from more carbon-intensive generation to efficient, low carbon-intensive generation and renewable power within the energy sector. To this end, we urge the Committee to recommend that the Air Resources Board (ARB) auction 100% of emissions allowances for all capped sectors from the outset of the emissions trading program. Calpine also urges the Committee to recognize the unique circumstance of independent power producers operating under pre-existing contracts which prevent carbon cost recovery. The Committee should recommend allocation of a limited quantity of free allowances to these producers since they have no way to recover program costs and therefore would be unduly harmed. Similarly, combined heat and power facilities operating under pre-existing contracts for power and/or thermal energy which prevent these facilities from recovering carbon costs need to be protected from economic harm via a free allocation of allowances for emissions under those contracts.

If the Committee does not recommend auction of 100% of allowances from the program onset, then Calpine advocates allocation of allowances to first jurisdictional deliverers on a fuel-neutral, output-basis that is regularly updated.



**The Committee should recommend that ARB auction 100% of allowances from the outset of the program**

Auctioning of allowances has numerous advantages over a free allocation of allowances to entities covered by the cap and trade system.

- Auctioning is the most efficient means of allocating allowances as it is simple, transparent and can be accomplished with relatively low administrative overhead, as experience in the RGGI program demonstrates.
- Auctions avoid the need for government to develop and implement a complicated and politically contentious allocation methodology. Auctioning places new entrants on the same footing as existing entities without the need to carve out special allowance set-asides for new entrants. It also avoids the need to develop special rules to address facility closure.
- Auctioning rewards early-action, because firms that have invested in clean technologies and energy efficiency prior to the advent of the cap and trade system benefit by having to procure fewer allowances for compliance.
- Auctioning captures allowance revenues so that they can be used to lower the state's overall cost of reducing GHG emissions, e.g. through funding of additional carbon-reduction activities, investments in energy efficiency, and research and development of low-carbon technologies.
- Auction of allowances ensures that compliance costs for individual entities reflect actual emissions and eliminates the concern of windfall profits.

With respect to the electricity sector in particular, opponents of auctioning argue that free allocation of allowances is necessary to compensate power producers for the potential loss of market share and asset value that would occur if they were required to pay for allowances. However, with the exception of the two narrow cases we discuss below, power producers and other first deliverers will have an opportunity to recover their compliance costs under California's cap and trade program. Independent power producers will generally recover compliance costs by incorporating these costs into their bid prices and wholesale electricity contracts. Utilities will seek recovery of CO<sub>2</sub> costs through the Public Utility Commission rate-making procedure or municipal Board process.

For these reasons, Calpine urges the Committee to recommend that ARB auction 100% of emissions allowances from the outset of the program. The exceptions to this general recommendation are the case of independent power producers that sell power or thermal



energy under existing long-term contracts that do not allow for recovery of carbon costs. These producers would suffer economic harm under a full auction scenario.

**Limited allocation of allowances should be made to generators that can not recover costs**

As we noted above, power producers have an opportunity to recover carbon compliance costs in wholesale or retail electricity rates. However, many independent power producers are currently operating under long-term contracts that predate Assembly Bill 32 and accordingly do not contain provisions for recovery of carbon costs. Those generators remain subject to the terms of their sales contracts, and it is unlikely their counterparties would accept contract changes to allow cost recovery. Free allocation of allowances is therefore warranted in the early years of the cap and trade program to compensate for the carbon costs incurred by independent power producers under these contracts.

Similarly, Combined Heat and Power (CHP) facilities are faced with a unique circumstance that limits their ability to recover carbon costs. A CHP facility produces CO<sub>2</sub> emissions related to the production of two types of energy (power and thermal). CHP units are typically located adjacent to industrial facilities and operate pursuant to long term contracts with their industrial hosts for power and thermal sales. Often, excess power output is sold to the wholesale market. A CHP generator can recover its CO<sub>2</sub> compliance cost related to power sold to the market by reflecting this cost in electricity prices. However, it cannot recover carbon costs for electricity or thermal output consumed onsite pursuant to long term contracts that predate AB32. Because CHP typically has much lower CO<sub>2</sub> emissions than separate power generation and thermal production, it is an important part of California's efforts to reduce GHG emissions. It is therefore important that the cap and trade system not disadvantage CHP relative to other power generators.

To address the problem of existing long-term contracts, Calpine recommends establishing an allowance set-aside. Generators under long term contracts can apply for free allowances from the set aside pool to cover CO<sub>2</sub> emissions from the portion of their power and thermal energy production obligated under existing long-term contracts or on-site consumption. In order to qualify for free allowances, applicants should be willing to submit a copy of their respective contracts (subject to appropriate confidentiality protection) and certify that they are unable to amend the terms of the contract to allow pass-through of CO<sub>2</sub> costs. This approach has been implemented by several of the states participating in the Regional Greenhouse Gas Initiative (New York, New Jersey and Connecticut), and is being considered in federal legislative proposals.

**Any allocation of allowances should be on an updating, fuel-neutral, output-basis**



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In the event that the Committee does not adopt 100% auction of allowances from the onset of the program, than it should recommend that allowances are allocated to regulated entities on a fuel-neutral, output basis and updated regularly. Fuel-neutral, output-based allocation encourages and rewards investment in efficient and low-carbon technologies.

In contrast, free allocation of allowances on an historic emissions basis (grandfathering) favors older, dirtier, and inefficient plants, and prolongs the operation of these units, while cleaner, more efficient plants would be penalized. Such an approach is fundamentally incompatible with California's GHG emission goals under AB32 and should be rejected. A fuel-differentiated output allocation for FJDs define would also reward high-carbon generation and should also be rejected.

Calpine appreciates the opportunity to provide input on these important issues and the Committee's consideration of our concerns.

Respectfully,

Avis Kowalewski  
Vice President,  
Government and Regulatory Affairs