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Via Email
Dr. Steve Cliff
California Air Resources Board
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Subject: CARB Cap and Trade Workshop, June 25, 2013
Proposed Regulatory Amendments

Dear Steve:

BP America, Inc. submits these comments on the various proposals for cap and trade regulatory amendments discussed at the public workshop on June 25, 2013.

Cost Control
Board direction in Resolution 12-51 sets out what we believe to be reasonable parameters under which staff is to develop a proposal for incorporating additional cost control measures into the cap and trade program, including;

- Ensure allowance price will not exceed the highest price tier of the Reserve
- Maintain the environmental integrity of the program
- Are effective in a reasonable range of plausible conditions during the 2013-2020 period

If these are to be the criteria upon which various cost control measures are evaluated, we suggest that several of the measures discussed by both CARB staff and academic participants at the June 25 workshop do not meet these criteria.

In general, we believe strongly that the right cost control measures can and should avoid having problems occur in the first place – rather than simply attempting to address a problem once it has occurred. There is no reason or need to allow allowances prices to spike to the highest Allowance Price Containment Reserve (APCR) level before additional cost control measures take effect. The APCR was designed as a price cap. Cost control design measures are very different than a price cap – and these two very different design elements should not be conflated.

Cost control measures that suggest re-filling the (APCR) are fundamentally flawed because they allow prices to run up before any additional cost control measures are put in place. It is very likely that if the program gets to the point where the APCR is exhausted – or nearly exhausted – turmoil in the allowance and energy markets and a consumer backlash will result in swift action by the Governor or the Legislature with CARB losing control of the solution. Moreover, affected businesses dislocated by both the direct and indirect costs of high allowance and energy costs may be forced to make decisions to reduce, curtail or relocate production before prices reach the level of the highest APCR tier. So while potential action taken by the Governor or the Legislature in reaction to allowance price spikes may be warranted given the potential impacts on the economy from a swift and/or sustained run up in allowances prices, this sort of abrupt action can also have many negative consequences, can't undo decisions that have already been made by businesses – and can be avoided with proper planning and design.

Proposals which seek to re-fill the APCR are problematic for other reasons as well. It is difficult to envision a sound source of emission reductions to re-fill the APCR which meets both the direction of the Board under Resolution 12-51 and the language of AB32. Filling the reserve by borrowing from future, post-2020 emission reductions pre-supposes a program with a more stringent emission reduction goal (which is far from certain) and does not meet the direction set by the Board Resolution or the language of AB32 (both which require emission reductions within the 2020 timeframe). Re-filling the APCR with offsets begs the question – why not simply allow regulated parties to use more offsets directly, rather than having the government put in the position of buying large volumes of offsets over a short time period – and then charging regulated parties at the price of the highest ACR tier? Why is that a better solution than proactively allowing regulated parties to use more offsets on their own? Allowing more offsets to be used directly by regulated parties would introduce more low-cost emission reductions in a more timely manner and would greatly reduce the potential for the APCR to be exhausted. By waiting until the APCR is exhausted, CARB not only allows the problem to occur rather than avoiding it, but also allows the solution to be much more expensive –i.e. charging regulated parties for allowances at the highest ACR price tier.

To avoid these abrupt actions, to avoid CARB losing control of the solution, to stay within the requirements of both AB32 and the Board Resolution, and to increase the potential that problems are avoided in the first place rather than fixed after they happen – there are numerous, relatively simple design measures that CARB can put in place. We believe it is possible to design additional cost control into the system by working with the current design of the system – without the need to add on additional, complex and controversial design elements. These fixes include:

- Increase the offset quantitative limit and allow use of international offsets
- Increase liquidity in offset markets by establishing a registry that links CCO serial numbers to an invalidation guarantee
- Remove or Greatly Increase Holding Limits for Regulated Parties
- Allow Use of Allowance Vintages from Within the Year in Which the Compliance Obligation is Due – Not in Which it is Calculated

Greater Use of Offsets

The use of offsets that are real, additional, permanent and verifiable are a win-win-win for California consumers, for environmental integrity, and for the potential to position California to meet its challenging, longer term, emission reduction goals. Offsets are a win for consumers because they can provide lower cost emission reductions, thereby reducing impact on consumer prices. Offsets are a win for environmental integrity because while offsets can be viewed as a cost containment mechanism, they do so while maintaining the environmental integrity of the emissions reductions target. Every offset, so long as it meets rigorous standards, results in a quantifiable, equivalent reduction of GHG emissions. In this way, the use of offsets is vastly preferable to other cost control mechanisms (for example, a safety valve, or depending on borrowed future emission reductions) where the environmental integrity of the system is more difficult to uphold or assure. Lastly, as the public's acceptance of the cost of the program will likely be the factor that determines California's ability to meet the goals of AB32 (as well as longer term goals), the ability of offsets to reduce program costs will contribute to the potential of meeting longer term emission reduction goals.

The economic benefits of the broad use of offsets are substantial and real – and make them a perfect choice for controlling costs in a cap and trade program. In an analysis of the Lieberman-Warner Climate Security Act of 2008, the U.S. EPA concluded that the unlimited use of offsets results in a reduction in the cost of emission allowances of 71%. Conversely, USEPA concluded that if offsets are not allowed, the cost of emission allowances would increase some 93%[1]. More recent USEPA analysis of the Waxman-Markey American Clean Energy and Security Act of 2009, concluded that "the availability of offsets under the WM-Draft significantly influences the allowance price", and that "without international offsets, the allowance price would increase 96 percent"[2]. Charles River Associates (CRA) performed a peer-reviewed analysis of the role of offsets in implementing AB32. CRA concluded that the broad use of offsets in California could reduce program costs by 80%, minimize economic loss to the state by up to $40 billion/year by 2035, and prevent the loss of over 300,000 jobs resulting from leakage[3].

Proactively increasing the use of offsets will provide cost control in a manner that will reduce the potential for sharp increases in allowance prices – and reduce the myriad consequences of such a run-up. Proactively allowing greater use of offsets will allow regulated parties to plan – rather than having to react to regulatory changes that are put in place in reaction to allowance price spikes. Greater use of offsets will allow emission reductions to occur within the same timeframe as a reduction would occur under the current program – as is required by both the language of AB32 and Board Resolution 12-51.

[1] EPA Analysis of the
Lieberman-Warner Climate Security Act of 2008
S. 2191 in 110th Congress
March 14, 2008

[2] EPA Preliminary Analysis of the Waxman-Markey Discussion Draft The American Clean Energy and Security Act of 2009 in the 111th Congress 4/20/09

[3] The Role of Offsets in Enhancing the Cost-Effectiveness of AB32, April, 2008

In addition to increasing the quantitative limit of the use of offsets, we suggest allowing for use of international offsets – as was also suggested by several of the economists at the June 25 workshop. Allowing use of international offsets recognizes the efforts being undertaken by other countries and sends a signal to all corners of the globe that carbon reductions have value. We suggest that CARB consider an approach that allows for use of and creates individual quantitative limits on both international and domestic/WCI offsets. One approach would be a 10% limit on domestic/WCI offsets *plus* a 10% limit on international offsets.

Increase Offset Market Liquidity
Three to eight year invalidation risk in California Carbon Offsets (CCOs) is holding back liquidity in offset markets, and preventing a "commoditized" offset contact from being available to the market – which ultimately increases compliance cost for covered entities and consumers, negating the effectiveness of CCO's as a cost control measure. This invalidation risk unnecessarily causes compliance costs to increase because covered entities are forced to:

- Attempt to become experts in CCO contracts offered (and the associated risks), or
- Form their own emissions teams to originate offsets, and take on invalidation risks - themselves, or
- Not participate in offset markets, at all

Several entities are prepared to take on this invalidation risk for compliance buyers, by selling CCOs guaranteed against invalidation risk. These entities include investment grade energy companies and insurance firms.

However, the market cannot efficiently transact guaranteed CCOs without knowing who, exactly, guarantees the offsets against invalidation. This is derived from the fact that CCOs guaranteed against invalidation risk are only as good as the credit rating of the entity that is underwriting the invalidation risk.

CARB could foster liquidity of CCOs by establishing a registry whereby CCO serial numbers are linked to an invalidation guarantee - whether it is from a credit worthy entity such as an energy company or bank - or from an insurance underwriter. CCOs with serial numbers on this registry could then be purchased on a standardised exchange contract, such as ICE (provided there were criteria around the insurance terms or minimum credit rating).

Increase Market Efficiency and Liquidity, Reducing the Potential for Allowance Price Spikes
A broad, deep and liquid trading market is vital to the success of the cap and trade program. All entities that participate in the cap and trade program, but especially those with large compliance obligations, must have a reasonable level of assurance and certainty that they will be able to satisfy an allowance obligation in the market. As a party that expects to have a large allowance obligation who will need to utilize the market to satisfy this obligation, BP is deeply concerned by several of the Regulation's market rules that will combine to severely reduce the availability of allowances, reduce market liquidity and affect the ability to obtain the most efficient carbon pricing.

Allowances, and their ability to flow through the market freely, are what will keep the California carbon market operating smoothly and give compliance entities confidence in the market. If allowances are not able to flow through the market freely, there will be a serious crisis of confidence in the market. Unfortunately, several of the Regulation's design elements result in allowances being prematurely and unnecessarily removed from the market in a way that brings a high potential for grave consequences for liquidity, allowance availability and market confidence. These troubling design elements include very restrictive and unnecessary allowance holding limits and overly restrictive rules on use of allowance vintages. If properly adjusted, these market design elements can improve upon market efficiency and help ensure that the market will deliver the most efficient carbon pricing.

First is the allowance holding limit described in the Regulation. The holding limits described in the Regulation are irrespective of a compliance entity's allowance obligation – meaning that an entity with a very small allowance obligation is subject to the same absolute holding limit as an entity with a multi-million allowance obligation. The result is restrictive holding limits that represent a small fraction of the allowance obligation of compliance entities with large allowance surrender obligations.

Any holding limit must take account of a compliance entity's full compliance period allowance obligation (i.e. not only annual compliance obligation) *plus* the need to bank and hedge allowances. A holding limit that does not consider compliance obligation and banking/hedging removes important compliance flexibility from those who most need it – i.e. those with large allowance surrender obligations.

It is important to understand that the existence of a holding limit does not assure the avoidance of market manipulation – nor does the absence of an arbitrary holding limit allow for market manipulation. The largest carbon market in the world (the EU ETS) operates without an allowance holding limit, and we are unaware of any demonstrable manipulation issues in that market. Likewise, other major commodity markets operate with general prohibitions on market manipulation that do not require the imposition of arbitrary or across-the-board holding limits to help detect or enforce.

BP recommends against the use of allowance holding limits. The Regulation attempts to address concerns about holding limits by introducing a very limited exemption. However, the holding limit "exemption" is not really an exemption at all as in order to qualify for the "exemption", allowances have to be deposited in a compliance account from which they cannot be removed. If a very limited exemption is as far as the Regulation will go to address these concerns about holding limits - it must be an actual exemption from the holding limit - which means the allowances subject to the exemption can reside in the holding account.

Finally, the treatment and use of vintage allowances combined with the aforementioned market rules greatly increase concerns around liquidity and market confidence – especially at the end of a compliance period. As written, a significant percentage of allowances will be unavailable for trading in closing months of a compliance period due to the compliance accounts, holding limits and annual surrender. In the months preceding final true-up, compliance entities will be aware of the fact that they must hold enough of the proper vintage allowances in order to meet their final true-up (for this first compliance period, this will mean vintages 2013 and 2014). This will cause many compliance entities to conservatively bank the proper vintages, leading to little allowance availability, greatly reduced liquidity and a potential crisis in market confidence during the 2015 true-up period. These problems could be exacerbated by parties without a compliance obligation that bank and carry over allowances.

During this time, compliance entities will have in hand 2015 vintage allowances, allocated early in 2015. Unfortunately, the Regulation as written prohibits use of these allowances for use in 2015 true-up for the 2013-2014 compliance period. In order to increase allowance availability, liquidity and market confidence, the Regulation should allow use of vintages that correspond to the year in which the surrender must be made – as well as earlier vintages. A simple change here could greatly increase flexibility, allowance availability and market confidence.

Section 95856 (b) (2) should read:

> *To fulfill any compliance obligation, a compliance instrument must be issued from an allowance budget year within or before the year for which an annual compliance obligation is <u>to be surrendered</u> ~~calculated~~ or the ~~last~~ year for ~~a compliance period for~~ which a triennial compliance obligation is <u>to be surrendered</u> ~~calculated~~, unless:*

In conclusion, with respect to cost control measures, we hope CARB will understand that while maybe they would have preferred to keep the design as the system as – it appears policymakers and academics are now realizing that there is a "non-trivial" chance that prices in the cap and trade program could increase rapidly and exhaust the APCR. While, in CARB's view, some of these current design elements may have been nice to have in a low allowance price environment, keeping them is not worth the risk of increasing the upward pressure on allowances prices – especially when alternative cost control mechanisms introduce several unwanted and unnecessary risks or challenges.

Public Disclosure
BP understands and appreciates the objectives of transparency and public disclosure in regulatory proceedings and in the progress of meeting environmental goals. However, it is important to understand that disclosure of information to the public cuts both ways in regard to benefit or harm to the public. Public disclosure can provide reassurance and confidence in public policy and can satisfy a legitimate right for the public to know details about issues of interest to them. On the other hand, there is good reason to avoid public disclosure of certain sensitive business or market information where disclosure of such information could result in markets that are less competitive and efficient. The public benefits from lower prices of goods and services where markets are competitive and efficient.

With this in mind, it is important that the Cap and Trade Program's plan for public disclosure strike the right balance between reassuring and protecting the public. We are concerned that the proposal discussed by CARB at the 6/25 workshop does not strike this balance. The current regulatory language requires that the Executive Officer "releases information on the quantity and serial number of compliance instruments contained in compliance accounts in a timely manner" – *and* "protects as confidential the quantity and serial numbers of compliance instruments contained in holding accounts". Staff appears to be considering retaining the language that requires release of compliance account information while changing the language that requires that holding account information is held confidential. We believe this is a mistake and will result in a less efficient and less competitive market for compliance instruments – and hence higher cap and trade compliance costs.

We believe it is possible to utilize the existing regulatory language in a way that creates the proper balance between public disclosure and protection of confidential information - in a manner that maximizes benefit to the public. CARB <u>should not ever</u> disclose the account balances for <u>individual</u> compliance entities – including both compliance accounts and holding accounts. Disclosure of either or both of these accounts will tilt the playing field toward sellers of compliance instruments and allow sellers to charge higher prices for compliance instruments sold to compliance entities with an obvious and time sensitive need for these instruments. Higher prices for compliance instruments will raise overall program compliance costs – and will impact energy users.

Large compliance entities are already greatly disadvantaged under the current regulatory rules because of the strict limits on holding account balances that greatly reduce the compliance flexibility for these large entities. Moreover, individual entities with very large compliance obligations will likely have few options when it comes to the number of entities who they can deal with in these necessarily large transactions. If individual compliance account information is disclosed, sellers can make assumptions about the fact that these large entities are holding at or close to the very low and well known holding limits. When combined with public information on emissions (i.e. compliance obligation), these sellers can make a very accurate determination of the compliance instrument need of an individual entity – and determine timing of need based on required surrender dates. Publishing actual holding account balances for individual entities will remove any of the guess work for sellers and allow them to determine precise needs of individual entities. Limited number of sellers, combined with information that allows the sellers to determine what a buyer needs to purchase and by when puts the seller at a distinct advantage over the buyer. This unlevel playing field will lead to a less efficient and less competitive market – and needlessly higher prices for consumers.

A case can be made that confidentiality in an individual entity's compliance account is as important or perhaps more important than holding account information. This is because for large entities, it is possible to make accurate assumptions as to holding account information – based on the low limits for these accounts. This means that confidentiality of compliance accounts plays an essential role in protecting a compliance entity's ability to participate in the market in a fair manner and comply at the lowest cost. Lowest cost compliance greatly benefits the public.

In order to maintain a competitive market for compliance instruments, allow regulated parties to comply at lowest cost, and thereby reduce overall costs of the program and impact on consumers - real time information on account balances (both compliance and holding) of individual compliance entities must not be disclosed. We believe the current regulatory language allows, and the public need for disclosure can be served, by publishing only aggregated information on the compliance account balance of the entire market. This aggregated information on compliance accounts, coupled with entity-specific emissions data and generic compliance/non-compliance determinations for individual entities, we believe, strikes the right balance of informing and protecting the public.

Please don't hesitate to contact me should you have questions regarding this correspondence.

Sincerely,

Ralph J. Moran
Sr. Director, Governmenta & Public Affairs
BP America, Inc.

cc (via email): Edie Chang
Richard Corey