VIA E-MAIL December 15, 2010

Clerk of the Board
California Air Resources Board
1001 I Street, Sacramento
California 95814

Electronic submittal: http://www.arb.ca.gov/lispub/comm/bclist.php

Re: **Proposed Regulation to institute a California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, Including Compliance Offset Protocols**

Dear Sir/Madam:

Valero Refining Company – California and Ultramar Inc (collectively "Valero") appreciate this opportunity to provide comments regarding the California Air Resources Board ("ARB") proposed AB 32 Cap and Trade regulation ("AB 32"), as posted for public comment on October 28, 2010. Valero owns and operates two refineries in the state of California, with a combined throughput capacity of over 305,000 barrels per day. Valero refines and markets products on a retail and wholesale basis through an extensive bulk storage and pipeline distribution system. Additionally, Valero's affiliates own and operate one of the nation's largest retail operations, which has a significant presence in California, as well as 37 other states. Valero, on behalf of itself and its affiliates, is providing comments to relay the significant impact the Cap and Trade regulation will have not only on its California operations but on the people and economy of the State.

Valero fully supports, and herein incorporates by reference, the comments provided by the Western States Petroleum Association (WSPA) on the proposed Cap and Trade regulation. In addition, we have listed below several additional issues and concerns that we wish to expand upon further to lessen the impact and improve upon your efforts.

1. **The Costs that will be Incurred Under this Proposal are not Commensurate with the True Reductions in Emissions**:

As currently proposed, the draft regulations calls for reductions in the state-wide carbon cap of approximately 2-3% per year until 2020, in keeping with the primary objective of AB32 of reducing Statewide emissions of GHGs to 1990 levels (approximately a 15% reduction from 2008 levels, and a 30% reduction from projected 2020 levels[1]). However, the Cap and Trade

[1] *Climate Change Scoping plan*, Executive Summary; California Air Resources Board, Pg ES-1, December 2008

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regulation is but one tool the ARB is employing to achieve this goal. While the cap itself covers a majority of emissions in California, much of the reductions under this cap will be derived from other regulatory measures such as vehicle GHG standards, RPS, energy efficiency requirements, etc. Per the ARB Scoping Plan, GHG emission reductions from "the combination of Cap and Trade program and complementary measures" amount to 146.7 $MMTCO_2e$, of which 112.3 $MMTCO_2e$ are reductions driven by command-and-control regulations, requiring specific technological or programmatic work practices. These command-and-control regulations preclude the use of "purchased GHG allowances" to satisfy regulatory obligations, and consequently are outside the scope of a carbon trading program. The remaining amount, approximately 34.4 $MMTCO_2e$[2], only constitutes 20% of the reductions necessary under the cap.

With this information as context, it is Valero's contention that the structure of the proposed Cap and Trade Rule will place an overwhelming financial penalty on industry for relatively small "market-driven GHG emission reductions". This is because the Cap and Trade regulation focuses on "total carbon emissions" and not on reducing carbon emissions to meet the goals of AB32. Even to the extent that GHG emission are reduced to meet the 2020 goal, the ongoing financial burden of the existing carbon emissions will continue and have real-world impacts on our refining operations that are not adequately addressed. We anticipate the cost of this program to Valero and ultimately California businesses and consumers could approach $500 million by 2020 *at the floor (minimum) price mandated by this regulation* with little or no environmental benefit.

The draft regulation attempts to address this issue in the first compliance period by providing significant free allocations (100% for the first compliance period). We support this approach in that resources are directed at reducing emissions, as opposed to buying allowances. However, beginning in the second compliance period, the "Assistance Factor" as it is applied to trade exposed industries, begins to reduce in a significant stepwise fashion of 25% per compliance period.

- Valero contends that this reduction in the Assistance Factor will place a tremendous financial burden upon the industry, while doing nothing to actually reduce GHG emissions. We estimate this step-change will cost in excess of $10.7 million in 2015. This cost will likely increase each year, based on the floor price of carbon.
- Further, transportation fuels are proposed to be subject to the Cap and Trade beginning in 2015. The current proposal has no provisions for free allowances to cover transportation fuels and thus we expect an additional penalty in excess of $350 million, increasing each year, based on the floor price of carbon. The expenditures contemplated by this draft regulation are so significant that they cannot be absorbed by industry and remain viable.
- As the ARB states in Appendix J of the Cap and Trade proposed rule package, there is "certainty" of full cost pass-through to the consumer, **except for industry**. We caution ARB in their assumptions about the certainty of this position, not only due to the detrimental financial impact it could have on our company and industry if 100% pass through is not achieved, but of the impact of forcing the consumer to absorb an additional

[2] *Climate Change Scoping plan*, Table 2; California Air Resources Board, Pg 17, December 2008

financial burden when facing record unemployment, a struggling economy, and a staggering government deficit. If industry cannot include the cost of doing business in the price the consumer pays for its product, industry will fail or choose another venue in which to conduct business.

Finally, we wish to emphasize to ARB that, future planning of linkage notwithstanding, the Cap and Trade Regulation is predominantly a California-only program. The draft Cap and Trade regulation contains virtually no details regarding linkage to WCI, RGGI, the EU, or any other organization that might have potentially compatible cap and trade systems. Lacking these details with the beginning of the first compliance period only one year away, we do not foresee ARB developing the necessary regulatory structure, tools, and guidance to implement program linkage in a meaningful manner. Until further details develop for both 1) additional entities to develop a viable carbon market by 2012, and 2) ARB delineates specific details regarding the linkage of these programs, we view the California Cap-and Trade regulation as a state-only program that will have significant economic impacts due to its limited markets and place California businesses in a competitive disadvantage.

Valero offers the following suggestions which would better align the financial impact of this proposal with the goals of AB32:

- Significantly limit the reductions in the Assistance Factor for stationary sources. Arguments regarding high- vs. medium- trade exposure notwithstanding, limiting the changes in the A.F. to 1% or 2% per compliance period would provide the refining sector more of the trade exposure protection we seek, but would also limit the financial impacts and allow for resources to be spent on actual reductions as opposed to simply buying carbon allowances, without providing any tangible environmental benefit.
- Provide free allowances to cover transportation fuels. Over 90% of the allowance costs associated with this regulation will be to cover transportation fuels in 2015. This approach is not transparent to businesses or consumers. To facilitate a more efficient allocation of company resources, allowances should be freely distributed to cover the vast majority of fuels, reducing annually at 1% or less (1% is approximately an additional $3.6 million annually, based on the floor price).

These changes will bring the costs associated with the Cap and Trade regulation more in-line with the expected reductions and minimize the economic impact to businesses and consumers.

2. Integration with the Low Carbon Fuel Standard (LCFS):

To the extent that ARB proceeds with both the Cap and Trade regulations and the Low Carbon Fuel Standard (LCFS), ARB should provide a means by which allowances and/or credits may be used and transferred between programs to satisfy compliance obligations.

The LCFS program will potentially be the most cost-intensive program under AB32, second only to the proposed Cap and Trade regulation. Depending on the availability of “approved crudes”

not classified as High Carbon Intensity Crude Oils (HCICO), coupled with the availability and costs associated with blending biofuels, the impact to Valero of the LCFS regulations could easily reach the $100s of millions by 2020. Initial costs of this program in 2011 alone may exceed $10 million. These costs are in addition to the Cap and Trade costs. The ability to find cost-effective GHG emission reductions that could be commensurate with the carbon reduction requirements under the LCFS will be critical for an industry facing costs of this magnitude.

The LCFS program, through the life-cycle analysis of feedstock and fuel products, reduces the obligations for carbon reductions into a simple total tonnage of CO_2. From a scientific standpoint, nature is indifferent as to the means of emission reductions, whether a renewable fuel, an offset, or some other emission reduction within a facility's operation. Consequently, there is no scientifically justifiable reason why a reduction that generates a credit under the Cap and Trade cannot be applied for compliance purposes to the reduction obligations under the LCFS. Transportation fuel carbon is already planned for inclusion under the statewide carbon cap. The flexibility to apply emission reductions interchangeably between programs will have no impact on the cap, compliance, or the reduction obligations required by AB32, should ARB proceed with massively expensive program.

3. The Benchmarking Scheme Used to Distribute Free Allowances to Refiners Must be Dampened so that it Does Not Overly Penalize or Overly Reward Parties

ARB is considering a benchmarking system that accounts for the variation in energy efficiency between refineries that could be used as the basis to distribute free allowances. A successful benchmarking system that will recognize both the capital investments industry has made in energy efficiency, and the associated benefits in energy savings, is important to understanding the fundamental differences between members of an industrial group. On a monetary basis, when comparing investments and associated returns, these differences are small. Likewise, differences in energy efficiency within the industry group are also minimal and the difference in free allocations should reflect this fact.

The actual energy efficiency difference between the most efficient refinery and the least efficient refinery is only 15 to 20%. Therefore, the benchmarking scheme used should not vary in the amount of coverage of emissions that are given out as free allowances by more than 15 to 20%. This percentage should be applied to the required percent reduction. For example, if the industry as a whole had to reduce emissions by 10% then the difference between the percent allowances between the best in class and the worst in class should not be more that 15 to 20% of 10% or 1.5 to 2.0% (i.e. best gets 92% of required allowances and worst gets 88%). If the absolute percentage of 15 or 20% were used, then the best would get 110% and the worst would get only 70% of allowances needed. Clearly the best in class refinery cannot be three times more energy efficient than the worst, but that is the magnitude of the reduction required or allowances that need to be purchased if benchmarking is not applied fairly. The benchmarking issue has the potential to pick winners and losers and must be carefully developed and applied.

Valero strongly urges ARB to complete the regulatory development process prior to adoption, so that the totality of the impacts can be meaningfully reviewed by the impacted parties. Valero believes that, if crafted consistent with our recommendations, ARB would be minimizing the impact to industry, the economy and consumers. We look forward to the promulgation of a final rule that is reasonable, technically feasible, cost effective, and considers the practical impact on the consumer. On behalf of Valero and its affiliates, please contact me at (210) 345-4620 should you have any questions or need clarifications concerning our comments.

Sincerely,

Matthew H. Hodges
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Government Relations
Valero Companies