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August 11, 2011

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

**Subject: ConocoPhillips Comments on Proposed Modifications to the California Cap and Trade Regulations Released on July 25, 2011**

ConocoPhillips submits these comments regarding the proposed modifications to the California Cap and Trade Regulations released on July 25, 2011. ConocoPhillips Company has significant operations in California, including oil refineries and petroleum product pipelines and terminals. As the third largest U.S. energy company, we also have important operations throughout the United States and worldwide. We operate refineries and offshore facilities in Europe and we have gained important experience with greenhouse gas emission programs through the regulatory mechanisms that Europe has implemented.

In addition to the specific comments provided here, ConocoPhillips does support comments submitted by the Western States Petroleum Association.

ConocoPhillips supports the development of Federal climate change policy in the United States that is economically efficient and environmentally effective, but that ensures the availability of secure, affordable, and reliable energy. We believe that a mandatory national framework with international linkages will be the most effective approach to achieve meaningful impact on global greenhouse gas emissions. As such, we oppose development of a patchwork of state-level policies

However, in states that pursue such state-level policies and in which we operate and contribute to local economies, such as California, we continue to engage constructively in development of the policies to provide business sustainability concepts. Pursuant to that goal, we offer the following key recommendations:

1. **Eliminate the High Carbon Intensity Crude Oil (HCICO) component from the Low Carbon Fuel Standard (LCFS).**
   The HCICO component of the LCFS regulation disadvantages in-state refinery operations and does nothing to help meet the goals of the AB32 program. It will likely result in "crude oil shuffling" and in combination with the full LCFS program lead to loss of high-paying refining and related manufacturing jobs to other states and countries.

2. **Exclude transportation fuels from the State emission cap.**
   This element of the program is a clear overlap of the Federal Renewable Fuels Standard and the state LCFS programs. Adding the enormous burden of consumer carbon emissions due to fuel combustion to California's cap-and-trade program will overrun the program's capabilities and could compromise its success. The probable step-change in consumer product costs to cover this additive element for gasoline and diesel would only escalate leakage of jobs and businesses that rely on petroleum products.

3. **Classify California refining as "high risk" for leakage due to trade exposure.**
Crude oil and petroleum products are world commodities with strong competition in energy markets. Exposing California refiners to the additional cost of carbon from process emissions will place these local businesses at a disadvantage relative to international manufacturers.

4. **Reduce the severity of the program's start.**
The proposed initial 10% "set aside" of allowances is unexpected and not recommended. A graduated start of the program, as presented in the Scoping Plan, would give California consumers and businesses time to adjust to the cost impacts of this regulation. This is particularly relevant given the now truncated first period of the program.

5. **Benchmarking:**
   - ConocoPhillips supports the proposal advanced by the Western States Petroleum Association (WSPA). The CARB option of output-based benchmarking may be appropriate for other sectors but would be a gross mistake for the refining sector, create large inequities between companies, and could result in unintended consequences that are contrary to AB32 goals.
   - ConocoPhillips supports CARB's proposal for New Entrants and recommends that it be extended to facilities with "significant modifications" that required CEQA review and were completed in 2010.
   - CARB has established a benchmark for petroleum coke calcining that is noted as consistent with the Europe benchmark. This may or may not be appropriate for our specific calcining operation at our Contra Costa Carbon Plant. We will be in contact with CARB staff to understand the CARB basis and make recommendations for our operation as appropriate.

6. **Discontinue plans to mandate energy efficiency projects for the industrial sector.**
CARB has recently commented that it will consider rulemaking next year to mandate energy efficiency projects. This directly conflicts with the flexibility promised by the cap-and-trade program and our ability to control cost impacts on our customers.

7. **Eliminate or revise buyer liability in offset program.**
ConocoPhillips supports the industry proposal to establish a Compliance Buffer Account.

California's standalone actions on climate change will negatively impact on our operations and our plans for continuing operations in the State. The proposed cap-and-trade regulations are effectively a direct tax on our operations, products and customers. The provisions clearly are not fuel-neutral and place in-state refining operations at a disadvantage relative to other international operations and other energy supplies such as electricity. These higher costs will be felt by all energy-intensive businesses and will ultimately be borne by the citizens of the State in higher costs for goods and services.

Attached are our detailed comments on staff's proposed regulation. We welcome this opportunity to submit comments and look forward to working with CARB leadership and staff to further refine these regulations. If you have any questions regarding these comments, please contact Steve Smith, Manager HS&E Programs at 281-293-6070, Stephanie Williams, Manager of Government Affairs in our Sacramento office (as noted below), or me at any time.

Sincerely,

Chris R. Chandler

Chris Chandler
Manager, Los Angeles Refinery
ConocoPhillips Company

cc: CARB Board Members
Mary Nichols, Chair, California Air Resources Board
James N. Goldstene, CARB Executive Officer

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**ConocoPhillips Recommendations**
**California Cap-and-Trade Program**

**<u>Eliminate the High Carbon Intensity Crude Oil (HCICO) component from the Low Carbon Fuel Standard.</u>**

CARB has necessarily deferred the start of the HCICO program elements to provide time to modify and define the program. We thank CARB for this deferral.

As written, the HCICO component of the LCFS regulation disadvantages in-state refinery operations and does nothing to help meet the goals of the AB32 program. The Wood Mackenzie study concluded that it could result in "crude oil shuffling" where the processing of certain heavy world crude oils would simply shift from California to other U.S. and foreign refineries. Such an outcome provides no improvement in global greenhouse gas emissions and, in fact, can lead to increased emissions. Further, it creates immediate competitive advantages for certain in-State producers and refiners of California heavy crudes because these crudes are grandfathered in the program. Other in-State refineries are particularly disadvantaged because they have no crude oil production in the state of California.

The program also fails to address the fact that refineries outside of the State could process HCICO and then send the partially-refined intermediate or even finished products to California with no potential for enforcement. Any attempt to correct this disparity creates further complexities to the program with low likelihood for success.

The cumulative impact of these factors would clearly create an immediate competitive disadvantage for in-State refiners and lead to leakage of high-paying refining and related manufacturing jobs to other states and countries. ConocoPhillips has appreciated an opportunity to share these concerns with CARB leadership and staff over the last few months and will continue to do so.

*Recommendations:*

The HCICO component of the LCFS regulation should be eliminated for the reasons listed above. If CARB chooses to proceed, we strongly urge CARB to carefully evaluate and consider the five alternatives (and others) that the LCFS Advisory Committee has described. We strongly urge CARB to work with our industry to carefully evaluate these options and ultimately correct the inequities described above.

**<u>Exclude transportation fuels from the State emission cap</u>**

The cap-and-trade program should not be extended to transportation consumer emissions. This element of the program is a clear overlap of the Federal RFS and the state LCFS programs, stacking on multiple program costs to one transportation fuel. Cap-and-trade is not well-suited to address emissions from millions of distributed point sources such as automobiles. Inclusion of transportation fuel emissions within the cap-and-trade program will add a volatile carbon cost to the price consumers already pay for GHG control measures such as LCFS and vehicle efficiency standards. In addition, fuels under the cap will increase administrative complexity and the market price of emission allowances for all the other capped sectors. The huge additional burden of consumer carbon emissions due to fuel combustion will overrun the capabilities of the program and could compromise its success. The probable step-change in consumer product costs to cover this additive element for gasoline and diesel would only escalate leakage of jobs and businesses that rely on petroleum products.

Specifically, a carbon cost of $20/ton would add a fuel cost burden in excess of $3 billion per year to the California economy. In addition to individual consumers, much of this cost will fall to businesses and municipalities impacting small business owners, truck drivers, city bus and trash services, construction companies, rail services, and others. This carbon cost, along with the cost of compliance for LCFS and federal programs, will ultimately be reflected in the costs of all goods and services that rely on transportation.

*Recommendations:* CARB should not extend the cap-and-trade program to consumer emissions from use of transportation fuels. Instead, CARB should allow existing Federal programs to address GHG emissions in this sector. This is consistent with the approach adopted in the European Union.

Transportation emissions should be considered only if a formal review determines that this action is necessary and implementation would be more cost-effective than other policy approaches in achieving GHG reduction from the sector. If it is determined necessary to include emissions from the consumer use of transportation fuels in the cap-and-trade system, the program should be designed to 1) create a clear carbon price signal for consumers, 2) reduce obligated party exposure to allowance price volatility with respect to the consumer compliance obligation and, 3) help companies manage working capital requirements associated with the consumer emissions compliance obligation.

ConocoPhillips has considered various options for managing transportation fuel emissions in a cap-and-trade program. We believe the program outlined below could address some of the identified concerns.

<u>Fixed Price Allowance Program</u>

- The State would set aside the volume of allowances necessary to cover transportation consumer emissions from use of gasoline and diesel fuel.
- The State would establish a price for those allowances based on some average of recent allowance market prices. That price would be adjusted periodically.
- Only obligated fuel providers could purchase the set-aside allowances at the established price noted above.

The program would also have the added benefit of reducing unnecessary administrative burden while still achieving the intended program goals.

Stationary source emissions from the refining sector and other covered entities should not qualify for this set purchase price program.

We look forward to discussing this program in more detail with CARB leadership and staff.

**<u>Classify California refining as "high risk" for leakage due to trade exposure</u>**

The proposed regulations classify petroleum refining as "medium risk" for emission leakage with significant implications for allowance allocation to the sector in the second and third compliance periods (§ 95870). The California refining sector is in direct competition with domestic and foreign refineries. These non-California operations would not incur costs for refinery GHG emissions. Without appropriate protection, the fundamentals of the fuels market could force California refiners to curtail production or shut down. For instance, each 25% reduction in the allowance factor (high risk versus medium risk) adds approximately $150 million in annual compliance costs to the refining sector. Imports would likely increase from foreign refineries not required to hold allowances for refinery emissions. Large new refineries in India and the Middle East, with relatively low costs to operate, have been built or are planned. They are expected to have the capability to produce California-grade clean products for export to California as market conditions justify. Product imports to the U.S. east coast are significant due to world pricing and significant imports to the U.S. west coast are equally possible. The result would be lost California jobs, reduced State revenues, and decreased fuel system security at no net benefit to the environment.

CARB has appropriately classified the oil and gas sector as "high risk." The import of large ship cargoes of gasoline and diesel is common and is as possible as the import of crude oils.

*Recommendation*: CARB should classify the California refining sector as "high risk" for emission leakage through 2020 and issuance allowances on this basis.

**Reduce the severity of the program's start**

The proposed initial 10% "set aside" of allowances is unexpected and not recommended. A graduated start of the program, as presented in the Scoping Plan, would give California consumers and businesses time to adjust to the cost impacts of this regulation. This is particularly relevant given the now truncated first period of the program.

A set aside approach in effect increases the stringency of the program for regulated parties. A properly designed program with a graduated start will allow markets to be established unencumbered with uncertainties and fallback potential that is created by the special contingency accounts.

**Benchmarking - Methodology**

Of the two options that CARB has outlined in the draft amendments, ("Adjusted EII" and "Simple Barrel"), ConocoPhillips supports the WSPA Adjusted EII proposal. This methodology accomplishes the CARB goals of incentivizing greenhouse gas emission reductions, improvements in energy efficiency, and rewarding early action.

Output-based benchmarking may be appropriate for other sectors but would be a gross mistake for the refining sector. CARB's proposal for a "Simple Barrel" output-based benchmark for our industry would create large inequities between companies unrelated to greenhouse gas emissions and could result in unintended consequences that are contrary to AB32 goals. For example, this could reward the processing of certain crude oils in other States or countries and the importing of those intermediates to California for further refining. This does nothing to meet the goals of AB32 and could actually increase global emissions of greenhouse gases.

*Recommendation*:
CARB should adopt the proposed WSPA methodology.

**Benchmarking and Issuance of Allowances – New Entrants**

ConocoPhillips support CARB's provision to grant emissions to "New Entrants." ConocoPhillips strongly recommends that this provision be extended to facilities with "significant modifications" completed prior to 2011. The standards for a "significant modification" can be established with enough stringency to appropriately limit its use. For the refining sector, this could be defined as a project that required full CEQA review and exceeds certain production output thresholds.

*Recommendation*: CARB should expand the New Entrants provision for the issuance of allowances to recognize significant expansions and modifications in operations.

**Benchmarking - Petroleum Coke Calcining**

CARB has established a benchmark for petroleum coke calcining that is noted as consistent with the Europe benchmark. This may or may not be appropriate for our specific calcining operation at our Contra Costa Carbon Plant. We will be in contact with CARB staff to understand the CARB basis and make recommendations for our operation as appropriate.

**Discontinue any plans to mandate energy efficiency projects for the industrial sector.**

CARB has recently commented that it will consider rulemaking next year to mandate energy efficiency projects. This directly conflicts with the flexibility promised by the cap-and-trade program and our ability to control cost impacts on our customers.

*Recommendation*: CARB should discontinue any consideration of mandatory energy efficiency standards and only consider options in the future after the results from the cap-and-trade program are evaluated.

**<u>Offset Buyer Liability</u>**

CARB has maintained its ability to invalidate offset credits after issuance. In addition, CARB maintains that the Buyer shall bear the liability related to offset revocation. CARB has added an eight-year statue of limitations for revocation, but that does little to actually resolve the inherent risk of the Buyer's Liability clause. ConocoPhillips believes that CARB's ability to invalidate issued credits and require the buyer to replace the credit will have devastating impacts on the offset market. Covered entities may choose to forego the offset market due to the inability to clearly identify and mitigate the risks associated with offset revocation. This would eliminate one of the major tools CARB has identified as a "cost containment mechanism."

*Recommendation*: ConocoPhillips supports the proposal submitted by the International Emissions Trading Association (IETA), which involves a Compliance Buffer Account funded by a hold back of a certain percentage of credits from each offset project. CARB should also hold the responsible parties liable for making the system whole in the case of fraud or error. The IETA proposal, which is very widely supported by market participants including WSPA, would allow covered entitles to address risks associated with offsets and ultimately reduce costs related to compliance.