**Los Angeles Refinery**
1660 West Anaheim Street
Wilmington, CA 90744

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September 27, 2011

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

**Subject: ConocoPhillips Company Comments on Proposed Modifications to the California Cap-and-Trade Regulations Released on September 12, 2011**

ConocoPhillips Company submits these comments regarding the proposed modifications to the California Cap and Trade Regulations released on September 12, 2011. ConocoPhillips 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.

Earlier this year, the Company announced plans to separate the Refining & Marketing (Downstream) and Exploration & Production businesses into two stand-alone separate publicly traded corporations. This transaction is expected to complete by mid-year 2012. In California, this would mean a company dedicated to Downstream operations.

ConocoPhillips also submitted comments on the initial rulemaking in December 2010 and on the recent revisions package issued July 25, 2011. ConocoPhillips also supports comments submitted by the Western States Petroleum Association (WSPA) and the International Emissions Trading Association (IETA).

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. Elements of the ARB's planned program picks winners and losers within the State and creates competitive disadvantages for in-state operations that will encourage the import of fuel from out-of-state and international refineries.

Not withstanding ConocoPhillips' preference for a mandatory national framework with international linkages, 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. **Reduce the unexpected severity of the program's start. Eliminate the recently announced 10% cut in initial allowances from the industrial sector.**

The proposed initial 10% reduction and set-aside of allowances is unexpected and unnecessary. 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 Compliance Period of the program which is now two instead of three years. ConocoPhillips opposed this 10% cut in our August comments when it first appeared in proposed public rulemaking and has met with staff to communicate our competitive concerns.

Our position is supported as follows:

- **Not a Slow Start:** This is not the "slow start" that was discussed for the start of the program.

- **Change not anticipated:** ConocoPhillips, and in our opinion the refining sector in general, did not anticipate this proposed late change in the regulation. To the best of our knowledge, it was only made clear for the refining sector in the July 25 public release.

- **Not aligned with prior ARB/WSPA discussion:** During the cooperative workgroup meetings on refining benchmarking earlier this year, the documents and examples on allocations discussed with ARB staff clearly assumed only a 4% or less (3.7%) cut in allowances due to the cap reduction during the first Compliance Period. Discussions did not include the 10% cut <u>plus</u> the 3.7% cap reduction now proposed by ARB. This 13.7% total initial cut is not a slow start.

- **Step Change in Costs**: This significant loss in allowances to ConocoPhillips and the accompanying high costs would hit on January 1, 2013, only 14 months from now. Based on current refining sector benchmarking these costs could range from $5 to $10 million per year based on ARB's <u>**minimum**</u> 2013 carbon market price of $10 per tonne (because this is the minimum price, the actual costs are expected to be much greater). These costs have not been assumed in our business planning and allocation of funds. Actual costs may be higher with higher carbon market prices.

- **Importing Refineries not Subject to this Cap-and-Trade Cost**: No refinery outside of California is subject to this requirement to buy allowances or offsets for refinery emissions. This creates a competitive disadvantage for California refineries that will be quickly exploited by foreign and out-of-state refineries.

- **Immediate Trade Exposure**: ARB recognizes the refining sector as heavily trade- exposed in the first compliance period by granting the sector a 100% "Industry Assistance Factor" in the Regulation's Section 95870. The newly proposed 10% cut is inconsistent with this recognition and degrades the protection ARB previously realized was necessary for our heavily trade-exposed industry.

  As a result of the 10% cut, trade exposure, which is already present, would increase on January 1, 2013. ARB has acknowledged potential leakage in industry operations in earlier rulemaking documents and that it can actually increase global emissions.

- **Refinery Viability and Jobs Impact**: Any additional trade exposure puts our refineries at a disadvantage, impacting viability, and potentially putting high-paying manufacturing jobs at risk. Further, a refiner will be less inclined to invest in the sites and that could put construction and other trade union work in jeopardy.

- **Heavy Overlay of Programs:** The 10% cut in allowances poses yet another overlay of AB 32 programs on the refining industry. This overlay includes at least five regulations that include the Low Carbon Fuel Standard for gasoline and diesel fuels, penalties for high carbon-intensity crude oils, Cap-and-Trade for refinery emissions in 2013, Cap-and-Trade for consumer product emissions in 2015, and the AB32 Implementation Fee regulation. This year alone we will pay $3.7 MM in fees to ARB for AB 32 regulation and program development. The imposition of Cap-and-Trade for product emissions in 2015 is problematic and we look forward to discussing this with ARB in future Cap-and-Trade rulemaking improvements.

- **Revenue Take for Unclear Uses**: It is not clear how the revenues from the 10% cut in allowances will be used. ARB does state that the proceeds from the sale of these allowances will be deposited into the Air Pollution Control Fund and will be available for appropriation by the Legislature for the purpose designated in California Health and Safety Code sections 38500 et seq. The uses of this significant additional revenue from the 10% cut should be made more transparent. Only 1.5% of the total is clear for use in the Allowance Price Containment Reserve and Voluntary Renewable Electricity Reserve Account. ARB has stated publicly that the AB 32 program should raise approximately $500 million in revenue from the sale of allowances in 2013.

**2. Amend the Refinery Benchmarking Methodology to Recognize New Cuts in Allowances**

ConocoPhillips <u>conditionally</u> supports the proposal advanced by WSPA.

ConocoPhillips offers only conditional support because the WSPA methodology, as proposed to ARB for Period 1, was constructed and negotiated by WSPA members before the ARB's addition of the 10% cut. It assumed that the cut in free allowances would be in the range of ARB's stated 2012-2014 cap reduction of 3.7%. The much larger and additional 10% cut in allowances described in item 1 above makes the model operate in ranges that it was not designed for. This creates very large competitive differences of up to 20% or more in allowances provided to individual refineries. These misaligned competitive differences not only create severe competitive inequities between California refineries but also impose costs that are not placed on importing refineries as described above. Consequences unintended by ARB will most likely occur with the large disparities between in-state refiners and with international refineries created by this added burden. If CARB proceeds with the additional 10% cut in initial allowances, ARB and WSPA should again work cooperatively to further refine the EII-based methodology to address the new competitive concerns.

Further, ConocoPhillips strongly disagrees with ARB's statement in Appendix A that this methodology "should address concerns expressed by refinery stakeholders about transition risk and short-term competition issues between in-state refining facilities." The 20% difference in allowances shown in Figure 2 of Appendix A does not at all address short-term competition issues. Further, Figure 3 can be misleading in that it assumes that every California refinery will be able to secure the full 8% of allowable offsets during the first Compliance period that starts in only 15 months.

ConocoPhillips supports ARB's proposal for New Entrants. There is no definition of New Entrants provided in the definitions section of the regulation. We will assume that this also applies to very significant expansions of a facility that have or will require CEQA review and exceed a significant threshold that is considered and approved by the Executive Officer. For the refining sector, ConocoPhillips recommends a threshold of 10% increase in clean product volume (gasoline, diesel, jet fuel) or a 10% increase in crude capacity. WSPA has also presented a similar recommendation to ARB staff.

**3. The offset program will not function to mitigate the additional 10% cut in allowances. Eliminate or revise buyer liability in offset program.**

ConocoPhillips is not confident that offsets with approved protocols will be available in 2013-2014 to substantially reduce the additional costs to refiners imposed by the 10% reduction in allowances.

ARB has maintained its ability to invalidate offset credits after issuance. ARB has maintained that the Buyer shall bear the liability related to offset revocation. While ARB has tightened the statue of limitations to five years if a project undergoes a second verification after three years of issuance of the credits, this does not do enough to ensure a robust offset market that meets the cost containment function ARB initially intended. ConocoPhillips believes that ARB's ability to invalidate issued credits and require the Buyer to replace the credit – in effect making the Buyer "pay twice" – 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.

In Appendix A of ARB's 2nd 15-Day Cap-and-Trade Regulatory Text, ARB makes assumptions that are based on "maximum usage of offsets". This "maximum usage of offsets" will be completely undermined if Buyer's Liability remains a part of the cap-and-trade program. With the inability to identify and mitigate risks, covered entities will be reluctant to utilize and maximize their potential usage of offsets. Because of this reluctance by covered entities, offset developers will not be able to ensure demand for projects thus making financing of projects infeasible. This spiral will significantly retard the offset market and make the "maximum usage of offsets" scenarios which ARB identified infeasible.

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. ARB 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 entities to address risk associated with offsets and ultimately reduce costs related to compliance.

In conclusion, California's standalone actions on climate change will negatively impact 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 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.

It is not clear to us that the Cap-and-Trade program is ready for implementation in 2012-2013. New developments such as the 10% cut in allowances and its impact on companies need broader evaluation. We ask that the ARB consider deferral of the start of the program to resolve these and other uncertainties.

We welcome this opportunity to submit comments and look forward to working with ARB 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 or Stephanie Williams, Manager of Government Affairs in our Sacramento office at 916-447-5572.

Sincerely,

Chris Chandler
Manager, Los Angeles Refinery
ConocoPhillips Company

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

For further information, please contact:

Stephanie Williams
ConocoPhillips, Manager of Government Affairs, West Coast
1201 K Street, Suite 1930
Sacramento, California 95814
916-447-1698