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Re: Cap on Greenhouse Gas Emissions and Market Based Compliance Mechanisms – Proposed 15-Day Modifications (September 12, 2011)

Thank you for this opportunity to submit comments on the cap and trade regulations proposed by the Air Resources Board ("ARB") on September 12, 2011. Chevron has been a California company for more than 130 years and is the largest Fortune 500 corporation based in the state. We have actively participated in stakeholder meetings, broad-based industry and environmental group meetings and discussions with ARB and its staff in order to make the program and this proposed rule workable for California, while meeting the goals of AB 32.

This second 15-day package represents a significant improvement in a number of key policy areas including the treatment of California's unique energy resources. However, it does not go far enough in addressing the rule's negative impacts on companies that have made large investments in the state. In addition, the package retains an initial stringent benchmark that nullifies the gradual transition to the program. We hope that ARB will carefully consider the impacts of deciding against a "soft start" to the program. Finally, we look forward to continuing to work with ARB in 2012 on several critical issues, including allowance allocation, trade exposure, offset protocols and market design.

Revised Benchmarks are Significant Improvements

We recognize that a well-designed cap and trade program that is effectively linked with other programs around the world can be the most cost-effective mechanism that ARB has in its arsenal to achieve the goals of AB 32. We appreciate that the second 15-day package includes benchmarks for refining and oil and gas production that are based on energy efficiency and reward early action, without penalizing complex refineries or California's unique oil and gas industry. We believe that by using complexity weighted approaches similar to those used in the European Union (EU), even better methods can be developed to promote refining efficiency.

Unintended Consequences of a "Hard Start"

We understand that ARB wishes to lead other jurisdictions to reduce greenhouse gases and that it also wants to reward companies for doing business in California in order to avoid leakage. However, rushing into an overly stringent program too early may work against both of these goals.

It is widely understood that it takes time - often several years - to make physical and equipment changes in industrial operations in California due to permitting and public review processes, both of which will be required before any significant actual emission reductions can be achieved. Consequently, companies will not be able to make emission reductions quickly and will have to rely on offsets and allowances in the short term. The cap and trade program provides flexible options to minimize the cost. This is the most important strength of a market mechanism. The current benchmarks/hard start will result in significantly higher prices for both allowances and offsets because companies will need time to develop and implement less expensive emission reductions. These high prices will create further competitive disadvantages for California companies compared to their out-of-state competitors. This, in turn, will discourage other states and provinces from adopting a similar program, decreasing the likelihood of linking to them. The result is a growing negative impact on the California trade-exposed companies who remain in the state.

A slow transition period that increases the benchmarks in the second and third compliance periods over the duration of the program would allow for both a reasonable economic transition and the development of a robust offset supply and cost-effective emission reduction investments.

Critical Items for 2012

Chevron understands - based on conversations with ARB staff - that while this 15-day package represents the completion of the December 16 rulemaking, several important issues will be considered next year. The most critical of these include linkage, trade exposure, offset supply, EITE allocation for electricity use, and market design issues. We understand further that two of these issues - linkage and trade exposure - were not addressed in either of the 15-day packages because they are scheduled for 2012 stakeholder engagement and rulemakings. While we recognize that ARB delayed addressing these issues until details of the allowance allocations were completed, they are critical to preventing a costly California-only program that is ineffective in meeting the goals of AB 32 and damaging to the state's economy. Without linkage and an adequate supply of offsets, the program will not be able to function in an economically efficient manner. Trade exposure to out-of-state competitors creates competitive disadvantage for California's refining and production sectors and threatens California's economic well-being and energy balance. We provide recommendations for addressing the topics covered in this rulemaking below:

- **Importance of Soft Start** – ARB should provide 100% free allowances to industry to prevent leakage of jobs and emissions out of the state, consistent with the December 16, 2010 cap and trade rule. One way the agency can provide a soft start to benchmarking and still achieve its objectives is to set the benchmarks at 98% of the industry average in the first compliance period, followed by 93% in the second period and 90% in the last compliance period. This will allow transition time for reductions to be made and for offset supply to be developed.

- **Upstream Benchmark** – We appreciate that ARB has adopted an energy based upstream benchmark that recognizes California's unique oil and gas resources. However, since much of the rulemaking and public participation was delayed in 2011, it is not clear how the actual calculations were performed. Since benchmarking data were gathered before verified data collection was completed, and because the benchmark is an average of industry information, it is impossible to reproduce the data and the table in the rulemaking. We understand that ARB is willing to work with stakeholders to ensure that the benchmark, as well as the assumptions behind the supporting data, are both consistent and correct, and we look forward to working with ARB on this issue.

- **Trade Exposure due to Electricity Allocations -** The use of electricity is a significant cost to industry in California. If CARB ignores the additional costs that will be imposed on both the refining and oil and gas sectors by increases in electricity costs due to the pass-through of carbon costs, these sectors will be competitively disadvantaged, resulting in carbon leakage. We are also concerned that grid purchases are completely covered and are not diluted by the CPUC rulemaking. We understand that ARB staff has agreed that direct allocations will be provided to industry after the CPUC acts on utility pass-through rules and before the start of the first compliance year, and strongly encourage that agency action.

- **Offset Protocols** – The protocols in this second 15-day administrative rulemaking are being revised in the right direction, but the revisions do not go far enough. Two key actions are necessary to support the development of a robust offset market that will lower compliance costs and ultimately reduce the program's impact on the California economy. First, we strongly encourage ARB to continue evaluating and adopting additional protocols for compliance under AB32. As more protocols are adopted, the supply of high quality offsets will increase and will drive down overall offset and compliance costs to the market. Second, ARB quickly needs to establish a process and requirements for entities to convert early action offsets into compliance-grade offsets. The sooner this happens, the sooner market participants will make investments in early action offsets. This will jump start the establishment of a robust offset supply that will be able to meet the demand, especially in later compliance periods.

- **Market Design Issues** – While many of the changes in the market design (such as increased purchase limits) will have a positive effect on developing an efficiently functioning market for all participants, several significant policies remain that threaten to diminish the effectiveness of the market and hinder economic recovery. The holding limit provision creates inequitable impacts on larger covered entities imposing constraints on their ability to participate in the market and optimize trading activity and requiring earlier surrender of allowances compared to those less impacted by the holding limits. In addition, the issue of offset supply becomes even more critical as we rely on it to address impacts to companies from the stringent benchmarks and changes in industry assistance. Therefore, we are even more concerned that offset liability will cause offset supply to be unduly reduced and that any offsets generated will be more costly due to the increased transaction costs from the liability requirements. We believe that taking allowances from the price reserve to replace invalidated offsets is the most cost-effective mechanism to address offset liability. This spreads the minimal cost of replacement among the entire market, which is the most cost-effective liability solution. Without changes to address these issues, large covered entities that invested heavily in the state and created jobs for Californians will be unfairly disadvantaged.

- **Affiliate Definition** – The changes made in the definition of affiliates mark a significant improvement in the cap and trade rule. However, it would be helpful to obtain clarification on Section 95833(1) (A) to ensure that a right of first refusal is not equated with the “right to acquire” or “option to purchase” so that an entity is not deemed to have a corporate association with another merely because it holds a priority right to obtain an interest in that other entity exercisable only when that interest is being offered to a third party. A “right to acquire” or “option to purchase” means that the power to trigger the transaction rests with the potential buyer. In other words, the “buyer” initiates the sale by exercising the right/option to purchase the shares. This differs from a “right of first refusal” in which the authority to trigger the transaction rests with the owner, and the buyer only has the right to be offered the shares the owner decides to sell. *See, e.g., Campbell v. Alger*, 71 Cal.App.4th 200, 206-207 (1999) (A right of first refusal is the *conditional* right to acquire property, depending on the owner's willingness to sell. The right does not become an option to purchase until the owner of the property voluntarily decides to sell the property and receives a bona fide offer to purchase it from a third party.)

Additional comments from Linklaters on holding limits are attached.

We appreciate the hard work and time that ARB has spent with our industry and the other stakeholders to attempt to develop a cap and trade program that will help reach the goals of AB 32 and reduce negative impacts on California’s economy. We look forward to continuing our work with ARB to help make this proposed rule workable for California, while meeting the goals of AB 32.

Sincerely,

via e-mail

Stephen D. Burns