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Clerk of the Board
Air Resources Board
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By Email

September 27, 2011

Our client Chevron Corporation ("**Chevron**") has asked us to review certain aspects of the revised draft of the Air Resources Board's ("**ARB**") cap-and-trade regulations, proposed September 12, 2011 (the "**Regulations**"). This letter follows our earlier letter dated August 11, 2011 (the "**August Letter**"), which was submitted as Exhibit 1 to the comments filed by Chevron with ARB on that date. Chevron has asked us to prepare this submission to follow up on stakeholder meetings with ARB and to discuss certain aspects of our August Letter in more detail. As in August, our comments here are limited to specific market-related concerns raised by the Regulations, and are based upon our knowledge and experience with other carbon and commodities markets in the U.S. and the European Union, Germany, France and the United Kingdom.

This letter is submitted as Exhibit 1 to the comments filed by Chevron with ARB on September 27, 2011 in connection with the Regulations. Linklaters LLP is a leading global law firm with over 2,200 attorneys in 19 countries. Our global approach and commitment to excellence ensure the highest standards of quality and service across all our relationships. Linklaters' Global Climate Change Practice comprises more than 20 lawyers in New York, London, Paris, Berlin, Beijing, Singapore and other major regions of the world. Together, we have advised governments, companies and international organizations on a full spectrum of policy issues associated with climate change. We have worked on more than 150 carbon transactions covering a wide range of structures and have a deep understanding of carbon markets. In addition, we are active members of the International Swaps and Derivatives Association, Inc., the International Emissions Trading Association and the Carbon Markets & Investors Association, and contribute regularly to the development of new market standard trading documentation.

This letter addresses several issues related to market design and cost containment, each of which arise as a result of ARB's approach to holding limits in Section 95920 of the Regulations. As a covered entity under the Regulations, Chevron supports the inclusion of mechanisms in the Regulations to mitigate the risk of market manipulation. Such mechanisms, however, should be carefully designed and narrowly tailored so as to fulfill their objectives without causing significant unintended consequences. While holding limits are one potential approach to mitigating the risk of market manipulation, the current framework for holding limits in the Regulations will result in discriminatory treatment of large covered entities that have invested significant resources in the State of California, and may result in other unintended consequences, such as granting a disproportionately large amount of market power to non-covered entities, including speculators.

1 ARB's Proposed Rule on Holding Limits has a discriminatory impact on large covered entities

The primary problem with the proposal on holding limits is that, instead of treating all entities within the same sector equally, it arbitrarily discriminates against and penalizes large covered entities, the very companies that have the most resources invested in the State of California. Because the current holding limit is lower than the compliance obligations of certain large covered entities but higher than the compliance obligations of all smaller covered entities and non-covered entities, large covered entities will be required to comply with the cap-and-trade program earlier than the smaller covered entities. This disparity has a significant economic impact on the large covered entities.

For example, assuming Chevron gradually acquires or holds allowances to track its emissions, the holding limit will require Chevron to comply earlier than its competitors by transferring into its compliance account significantly more allowances than the 30 percent prescribed in the proposal for 2013. As illustrated in the chart below (which is based on the most recent publicly available information), no other covered entity operating in the oil and gas sector will be impacted by the holding limit in 2013.

Chevron direct competitors (Top 9 emitters (direct, in-state) in oil & gas)	2008 emissions	Average Holding Limit for CP 1	Ability to Optimize Compliance during First year
Chevron	11,700,000	5,906,250	50%
ConocoPhillips	5,200,000	5,906,250	114%
BP	4,700,000	5,906,250	126%
Shell	4,700,000	5,906,250	126%
Tesoro	4,700,000	5,906,250	126%
Valero	3,800,000	5,906,250	155%
AeraEnergy	3,400,000	5,906,250	174%
ExxonMobil	3,200,000	5,906,250	185%
Occidental Petroleum	2,100,000	5,906,250	281%

As allowances moved into a compliance account cannot be withdrawn, the holding limit essentially requires Chevron to comply with the cap-and-trade program ahead of the prescribed deadline, in this case 16 months before any other entity in its sector. This design flaw will distort the market and make it more costly for Chevron to comply relative to its competitors, for no overall market benefit or rational policy objective.

The problem is only exacerbated during the second compliance period; by 2017, based on data provided to us by Chevron, we estimate that the number of allowances Chevron will need to move into its compliance account will exceed 100 million, whereas its closest competitor in the sector will have to move less than 50 million allowances into its compliance account in order to comply with the holding limit.

In addition, the holding limit will effectively preclude large compliance entities such as Chevron from minimizing their compliance costs by participating fully in the market. Although it is difficult to accurately value this opportunity cost, the prohibition is a significant limitation on the ability of these entities to use market mechanisms to comply with their legal obligations in the most efficient manner.

2 The holding limits are unprecedented and unsupported by the record

As we pointed out in our August Letter, there is no data or research that demonstrates or otherwise purports to show precisely what positive impact the holding limit rule will have on the carbon market. The holding limits contained in Section 95920 of the Regulations are derived from a rule designed by the CFTC to govern futures markets, in which regulators' leading concern was systemic risk, not market manipulation. ARB has pointed to no evidence supporting the extension of a rule designed for futures markets to the inventory market at issue here. Whereas systemic risk is indeed an issue in large, highly liquid futures markets, such risks will be non-existent by design in the California allowance market, where large covered entities will be engaging in the market primarily for compliance purposes and where relatively few counterparties will be exposed to any risk associated with such entities' market positions. Indeed, it is important to reiterate the conclusions presented in our August Letter, which explained that there are no other commodities markets and no other major carbon markets in existence, either compliance or voluntary, including the German, French, UK and EU-wide emissions trading systems, with a holding limit.

The only rationale ARB has provided to justify its approach to holding limits is contained in its "Staff Report: Initial Statement of Reasons" released in October 2010.[1] In that report, ARB cites the conclusions of Jeffrey H. Harris, a professor of finance at the University of Delaware and the author of a report on holding limits prepared for the Western Climate Initiative Markets Committee (the "**WCI Report**").[2] Yet this WCI report is not part of the record and was not subject to any notice and comment rulemaking procedures.

Had ARB formally included the WCI Report in the record, stakeholders would have had the opportunity to examine its conclusions and raise concerns about the applicability of Dr. Harris' logic to the specifics of the California carbon market. Specifically, stakeholders may have noted that the proposed limit is

1 ARB, "Staff Report: Initial Statement of Reasons" (Oct. 28, 2010), available at http://www.arb.ca.gov/regact/2010/capandtrade10/capisor.pdf.

2 Id., p. IX-105.

set below the compliance obligations of certain covered entities, a fundamental flaw that Dr. Harris never identified, discussed or justified in the WCI Report. In fact, Dr. Harris conducted his analysis for WCI at a time when multiple states and provinces were expected to join WCI. Since the holding limit is a function of the size of the cap, Dr. Harris' discussion and conclusions are based on market conditions that feature a much higher cap, at least double that of California's, that will not exist under the California proposal. Accordingly, the WCI Report is a poor tool to help guide policy decisions for the California carbon market.

3 Covered entities should be allowed to hold the number of allowances needed to satisfy their compliance obligations

In Exhibit 1, we have included a simple solution to address the increased costs and added burdens solely borne by large covered entities, which would maintain the holding limit as it is currently configured under Section 95920 but exclude from the limit the number of allowances needed by a covered entity to comply with its compliance obligation during the applicable compliance period. Accordingly, a covered entity holding the number of allowances equal to its compliance obligation is placed in the same position, for holding limit purposes, as a non-covered entity that does not hold a single allowance, thereby creating a level playing field among all market participants and entities within the same sector.

It is imperative that the appropriate changes to the holding limit are made now as opposed to next year or some other time in the future. Waiting until the future will result in a loss of the momentum necessary to make such changes, and implementing changes after the adoption of the Regulation could prove to be cumbersome, may result in confusion by market participants (including in connection with their underlying investment strategies) and would introduce unnecessary regulatory risk prior to any such adoption. We therefore propose the amended language in Exhibit 1.

4 The holding limit has a flaw that may allow speculators to exert excessive market power

Because the policy fails to distinguish between covered and non-covered entities, it may, under certain circumstances, exacerbate the possibility for market abuse, the precise outcome the holding limit policy was designed to mitigate. When a large covered entity such as Chevron is forced to shift allowances into its compliance account to comply with the holding limit, the size of the market will effectively shrink. Depending on the degree to which large covered entities must move allowances into their compliance accounts in order to comply with the holding limit, the policy may create a considerable reduction in market volume, effectively reducing liquidity. By constraining the amount of allowances circulating freely in the market, the holding limit policy increases the probability that any one market participant, including a trader or speculator, can acquire a position that would allow it to exert market power.

5 Increasing the frequency of auctions is the most efficient tool to control the risk of market manipulation

Research included in our August Letter demonstrates that the most effective way to curb the risk of market manipulation is to hold auctions frequently. More auctions reduce the risk of market abuse because of the decreased value at stake in smaller auctions. They also minimize price volatility experienced at the time of allowance auctions and the risk of any one market player exercising excessive market power between auctions. For those reasons, most agencies managing carbon markets have moved to a weekly auction schedule, including in Europe and Germany where, by law starting in 2013, auctions must be held on a weekly basis or more frequently. RGGI is an outlier whose design dates back to 2006/2007. The RGGI quarterly auction schedule has been largely untested, because the RGGI market is historically long (i.e. characterized by excess allowance supply) and trading activity is low.

We recommend that ARB use the 2012 auctions to identify any significant issues related to auction frequency and provide an opportunity for all market participants to experiment with the auction process. Starting in 2013, we recommend that ARB move to a monthly, semi-monthly or weekly auction schedule in accordance with the most recent research conducted worldwide on carbon auctions.

* * *

We thank you for the opportunity to comment on the Regulations.

Yours sincerely,

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Exhibit 1
Proposed Amendments to the Draft Regulations

§ 95920. Trading.

[....]

(d) The holding limit will be calculated for allowances qualifying pursuant to section 95920(c)(1) as the sum of:

...

(1) The number given by the following formula

...

(2) A Limited Exemption from the Holding Limit is calculated as:

(A) The limited exemption is the number of allowances which are exempt from the holding limit