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Shell Energy North America
4445 Eastgate Mall, Suite 100
San Diego, CA 92121
Tel 1+ 858 526 2109
www.shell.com/us/energy

California Air Resources Board
1001 "I" Street, P.O. Box 2815
Sacramento, CA 95812

RE: Notice of Public Hearing to Consider the Adoption of a Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, Including Compliance Offset Protocols

Shell Energy North America (US), L.P. ("Shell Energy") appreciates this opportunity to provide comments on the proposed cap and trade regulation. Shell Energy is an integral part of the Shell Trading network of companies, and a wholly owned subsidiary of Royal Dutch Shell ("Shell"). Shell Trading has more than a decade of experience in North American and global environmental markets, including the Regional Greenhouse Gas Initiative, Alberta's Specified Gas Emitters program, the U.S. Federal SO2 program, as well as multiple regional NOx programs and Renewable Energy markets, the European Union Emissions Trading Scheme ("EU ETS"), and the Kyoto Protocol's Clean Development Mechanism. Shell Trading was the first to transact EU allowances under the EU ETS, and the first to trade a futures contract on a US federal compliance instrument on the Chicago Climate Futures Exchange.

Shell supports the objective to stabilize GHG concentrations in the atmosphere at a level that would prevent a dangerous impact on the world's climate system. Shell's goal is to promote policies to both meet the energy challenge and address climate change in a manner that promotes California's economy. We support policies that are market based, that subject similar industries to the same standards, and provide a predictable long-term policy framework. We are committed to working with ARB to develop a workable cap and trade program.

We sincerely appreciate the time and resources that ARB has put into developing this draft cap and trade regulation. This final cap and trade draft regulation has greatly evolved from the Preliminary Draft Regulation both in detail and inclusion of some key concepts. We believe some of the concepts that have been included are vital to the workability of the program including transition periods, allowance reserve, increased offset use, recognition of energy intensive trade exposed industries, and the framework for recognition of sector based offset credits.

Despite the progress that has been made, there are more issues to be resolved and work to be done. Our comments in this letter will be limited to trading and market design issues since many of Shell's concerns with other aspects of this regulation are being covered through some of the trade associations in which we participate.

Holding limits must be adequate to meet compliance obligations

As currently written, adequate allowances could not be held by a compliance entity, such as Shell, to cover their obligations or to mitigate unacceptable price exposure. This problem is exacerbated during the 2nd compliance period when transportation fuels are included under the cap. Because of the large quantity of allowances that entities like Shell must surrender, we must have the flexibility to hold and trade sufficient allowances to meet our compliance obligations and minimize unacceptable risks.

Shell Energy believes there are rational grounds for establishing holding limits on physical allowances held in a registry account by participating entities. Based on discussions with ARB staff, we understand that ARB desires to retain a holding limit provision but that revisions are being considered. We recommend the following revisions to the holding limit provisions:

- Entities that have compliance obligations should be permitted to hold a number of allowances in their registry account equal to at least 3 times their rolling future annual average emissions obligations, to correspond with the 3-year compliance periods. Otherwise, an entity would be prevented from managing its price exposure for the full compliance period. The "rolling" aspect of the proposal is necessary to manage the step change in compliance obligation that occurs between the 1st and 2nd compliance period when transportation and commercial/residential fuels are added to the cap. An estimate of this future obligation could be calculated using data from previously reported years.

- For the purposes of calculating an entity's holding limit, that entity should be able to include any emissions obligations of its affiliates, and any contractual emission obligations of those entities.

- An entity should also be able to transfer allowances and offsets freely between its general account and its compliance account. Otherwise, allowances bought by a compliance entity and moved to its compliance account (in order to take advantage of the compliance entity holding limit exemption) would suffer extreme financial loss if prices suddenly fluctuated.

Establish credit thresholds for auction participants to minimize collateral requirements of creditworthy entities

Shell Energy believes that it is prudent for ARB to seek assurance that purchasers of allowances at auction have the financial capability to buy them. However, we believe that it is unnecessary to require investment grade credit rated companies to post bid collateral. Such guarantees are needlessly costly and time consuming.

We recommend that ARB establish credit threshold tables for investment grade companies based on their publicly reported credit ratings. These tables would provide maximum amounts that a qualified entity would be able to bid without posting additional collateral. The better the credit rating, the higher the credit threshold. If an entity wanted to bid for allowances with a value greater than its credit threshold, it would have to post collateral for any incremental exposure in the normal way.

Disclosure of information should be provided for transfers of allowances, not transactions

Section 95921 requires disclosure of transaction information. We understand that certain information disclosure is needed by ARB because the system of accounts maintained by the accounts administrator is the final record of who owns each compliance instrument and additionally, ARB needs to be able to determine if a transaction would result in an account holder exceeding the holding limit.

However, it is not necessary for a market participant to report every transaction for ARB to enforce allowance holding limits. When the trade settles, and allowances are transferred, the registry would be able to ascertain if the buyer has exceeded any holding limit at that time. Therefore, it is not necessary to report a transaction when the trade is executed.

In addition, it does not make sense to require reporting of all transactions for the simple reason that many transactions will be made on a financial basis (i.e. settled with cash and with no ultimate physical delivery of allowances) and in jurisdictions outside of California. ARB would have no ability to enforce reporting of such transactions, resulting in an unfair reporting burden on compliance entities subject to ARB penalties. In addition, ARB would have an incomplete data set on transactions that may not reflect market conditions.

We recommend that Section 95921 be amended to apply only to transfers of allowances, and not the actual transaction itself.

Price and date/time of trade should not be disclosed

Section 95921(b)(6) requires reporting of prices and Section 95921(b)(4) requires reporting of the date and time of a particular transaction. This presents some logistical challenges, as allowances are fungible, and will be held in inventory on an aggregate basis. In addition, there are commercial and competitiveness concerns with reporting prices.

Shell Energy considers the price of individual transactions to be strictly confidential. Knowing a competitor's previous pricing strategies can put that company at significant disadvantage in future commercial negotiations. In addition, the price for any particular transaction is just one component of a deal, and a somewhat misleading figure without an understanding of the risks and obligations of the two transacting parties. Accordingly, Shell Energy does not agree that this data should be required by ARB.

Many IT systems do not capture the time of a transaction, as it is often not pertinent commercial information. Requiring this information to be captured and reported would result in excessive costs on businesses having to comply with these reporting regulations.

We believe that ARB can achieve their objectives to monitor prices by allowing private companies to establish exchanges on which allowances and offsets can be traded. Liquid trading of standard exchange-based products is the best means of achieving price transparency in a traded market.

We recommend that Sections 95921(b)(6) and 95921(b)(4) be deleted.

Liability for offset reversals should be placed on project developers

Section 95985(d) requires the user or retiree of the offset credit to replace each metric ton of CO2e with another approved compliance instrument, in the event ARB determines that a previously issued offset credit is invalid. We understand the desire to ensure that offsets represent real reductions in emissions to safeguard the environmental integrity of the program.

However, Shell Energy believes that placing revocation liability on offset users, who usually have no direct control over an offset project or intentional reversal, will dramatically discourage the trading of such offsets, and drive the market towards inefficient, illiquid bilateral transactions with no price transparency; every transaction would have to negotiate liability for revocation. An actual revocation would trigger a

waterfall of contractual default provisions that would be costly to administer. Also, it would be impossible for an exchange to list a standard offset contract in this regard.

Only through frequent trading of offsets will reliable price signals occur, making it imperative to structure any government recourse in a way that does not impede the liquidity of the market.

We believe that ARB can achieve their intended objective of environmental integrity without placing the liability on the users of offsets. The proposed regulation would only allow offsets credits that meet the stringent ARB approved protocol and that have been verified by ARB approved verifiers. Section 96010 clearly establishes ARB's authority over project developers as well as purchasers/users of offset credits.

We recommend that the liability for invalidated/erroneous offset credits (for example due to intentional reversals, fraud or material errors/mistakes) be placed on the project developers that have control over and responsibility for operating successful offset projects. Therefore this section should be amended as follows:

Section 95985 (d) If an offset credit found to be invalid pursuant to this section, except as provided in section 95985(e) and (f), has been retired or surrendered for compliance in any voluntary or regulatory program, the project developer of that offset credit must retire an additional metric ton of CO_2e of another approved compliance instrument pursuant to sub article 4, within 30 calendar days pursuant to this section.

Process to replenish the Allowance Price Containment Reserve Account should be incorporated

Shell appreciates the provision to establish the allowance price containment reserve account. We support ARB's objective to create suitable cost containment mechanisms. However, we are concerned that the reserve will be insufficient to contain costs if the market is short, not because of a temporary event but due to unforeseen systemic issues. Through discussions with ARB staff, we understand that the intention would be to change the cap and trade regulation should use of the cost containment reserve indicate a structural supply/demand problem. While we understand the need for market-based programs to be amended over time to reflect changes in technology/economic conditions, such changes should be rolled out in a predictable and methodical way and not as a result of market /regulatory panic over a depleting cost containment reserve.

We recommend that a process to replenish the reserve with international offsets purchased by a neutral 3rd party be added to the regulation.

Forward Term Contracts at Fixed Prices Should Receive Free Allowances

Section 95811 requires generators and importers of electricity into California to account for the CO2 emissions associated with their power production and imports. Shell Energy understands the need to include emissions from the power sector under the cap and trade program. However, for generators located within, or connected to the California Grid that entered forward term contracts at fixed prices, this requirement may create an economic loss that was not accounted for at the time the transaction was executed.

We recommend that a portion of the allowances for each affected vintage year be made freely available to generators who entered into forward term fixed price agreements prior to the ARB Rules having been adopted in order to prevent penalizing those entities that transacted in good faith under existing regulations.

Sector based offset credits should not be geographically limited to US, Canada, and Mexico

Section 95991 allows the Board to consider acceptance of compliance instruments issued from sector based offset crediting programs that meet the requirements and originate from developing countries or sub national jurisdictions. However its restriction to "except as specified in sub article 13" seems to imply that the sector based offset credits are geographically limited to US, Canada, and Mexico. We request that you clarify that it is not ARB's intent to geographically limit sector based offset credits to US, Canada, and Mexico.

Thank you for this opportunity to comment on the proposed cap and trade regulations. If there are any questions, please contact Minnie Tsunezumi at (925) 313-3735.

Sincerely,

Marcie A. Milner
Vice President, Regulatory Affairs
Shell Energy North America (US), L.P.
Marcie.Milner@Shell.com
(858) 526-2106