Mr. Steven D. Smith
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May 16, 2018

Ms. Rajinder Sahota
California Air Resources Board
1001 I Street
Sacramento CA, 95814

RE: Phillips 66 Company (Phillips 66) comments on CARB's April 26, 2018 workshop regarding Amendments to the Cap- and-Trade Regulation

Dear Ms. Sahota:

Phillips 66 Company (Phillips 66) submits comments on the materials provided by the California Air Resources Board (CARB) in its April documents for the April 26, 2018 workshop and prior materials relating to potential amendments to the Cap-and-Trade Regulation (Regulation).

Phillips 66 has significant operations in California covered by the Regulation, including petroleum refining, coke calcining, and supplying of petroleum products. Our other business units include pipelines, terminals and lubricants manufacturing. Over 1,400 Phillips 66 California employees in 15 locations produce and deliver 2.8 billion gallons of product per year to our California customers. Phillips 66 is a large source of revenue for California governments; we pay approximately $13 million of in-State taxes and over $34 million in property taxes annually.

As a member of the Western States Petroleum Association (WSPA), Phillips 66 supports WSPA's comments. In general, CARB staff should make every effort to contain costs and ensure market liquidity. Regulations must be created within the requirements of AB 398's mandates of cost containment and price containment points to ensure California consumers and economy are unharmed. We provide the following specific comments and recommendations on the staff proposals to date:

1. **Perceived Overallocation and Banking:**

   The Cap-and-Trade program is a multi-billion dollar per year program that requires a stable design allowing regulated entities to plan years into the future. We continually evaluate and make business plans based on our current understanding of the myriad regulations which include Cap-and-Trade, Low Carbon Fuel

Standard, AB 617 directives, local air quality management district standards and others, on top of California's already stringent gasoline and diesel quality requirements.

Capped-sector emissions have been lower than the program caps through 2016, and likely for 2017, and should be celebrated, rather than characterized in a negative view that the market could be "oversupplied". We believe the program is overachieving its goals to date. The minority of stakeholders that argue for a reduction in program allowances and more stringent banking rules advocate for a structure contrary to the basic premise of long-term program, which is to have total emissions below the cap through 2030. These minority-held positions also penalize California businesses that must compete globally. Current banking limits are not a detriment to the program and do not threaten the program's goals. CARB staff has repeatedly stated that they and the market monitor see no evidence of market manipulation.

The burden on Cap-and-Trade to deliver emission reductions is significant. CARB's own modeling results predict that Cap-and-Trade by itself must deliver 269 million tonnes (MMt) of emission reduction in 2021-2030 with the inclusion of 150 MMt unused allowances at year-end 2020. CARB staff also correctly notes that there are many uncertainties in understanding the State's GHG emissions profile between now and 2030.

Recommendation: Phillips 66 supports CARB's recommendation to retain the current program caps and to impose no other reductions in allowance supply during this rulemaking. It is premature to consider changes, and any reduction in supply could destabilize the market, creating winners and losers and add investment uncertainty. There is a known program touch point in 2025 to address the program's progress in achieving the State's goals. Phillips 66 also supports CARB's recommendation for no changes in the banking provisions which add liquidity and price-stability to the program.

2. Allowance Diversions to Future Reserve and Price Ceiling Pool

CARB asks for comments on various diversions of allowances away from the core auction volume in its discussion document. Any diversions beyond those specifically prescribed by AB 398 are counter-productive to the program. We count at least three places where provisions or restrictions would limit auction volume including treatment of unsold allowances, potential future APCR draws, and when volumes could be sent to the ceiling price pool as noted below.

A. Future "Reserve" Stocking

AB 398 directs approximately 40.6 MMt of allowances to each of two 2021+ "price containment points" based on the actual Allowance Price Containment Reserve (APCR) inventory of 121 MMt on December 31, 2017. This stocking of 81.2 MMt equates to a "Reserve" of 30% of the average annual program cap (2025) in the next decade.

This Reserve was established by AB 398 with one purpose: "to establish two price containment points". It was not designed to increase allowance price, make a correction for allowed offset use or to account for the difference in annual emissions versus cap as discussed by some. The opposite is true. It is solely and purely a cost control feature.

Recommendation: CARB should limit the diversion of allowances to the future price containment points or "speedbumps" to 81.2 MMt.

B. Unsold Allowances

More than 77% of all auctions to date (17 of 22) have been fully subscribed or over-subscribed. It is to us evidence that markets vary periodically during times of economic, regulatory or other uncertainty. Only five auctions, in 2016 and early 2017, had current-vintage volumes unsold (likely due to uncertainty resulting from pending litigation challenging the legality of the auction). Following this period, the auctions returned to full subscription and, in fact, the third quarter 2017 auction was oversubscribed by 79%. Across the 22 auctions, the average ratio of bids versus auction supply was 1.32 or 32% oversubscription. These facts demonstrate that overall demand is strong and will only strengthen given the prescribed cap declines.

The sound policy outcome of program design is liquidity. CARB should return unsold volumes to the regular auction. With AB 398's requirement to stock the price containment points with 81.2 MMt, CARB should maximize the number of all other allowances offered in regular auctions. This maximizes program liquidity and price stability which protects California consumers.

Existing regulation Section 95911(f)(3) limits allowances reintroduced to auction to 25% of the total allowances designated for that auction and only after two auctions have been fully subscribed. Further, existing regulation Section 95911(g) and AB 398 direct that allowances designated for auction "that remain in the auction holding account for more than 24 months be transferred to the allowance price containment reserve."

These three restrictions are direct hits on market supply and liquidity and conflict with the cost containment goals of AB 398. Only the 24-month provision is contained in AB 398 and this is open to interpretation for the period of 2021-2030.

Recommendation: Phillips 66 recommends that CARB lift the restrictions on the amount of allowances that can be re-introduced. We recommend removal of restrictions that would direct certain unsold allowances to the future price containment points and instead recommend that they return to auction. Specifically, we recommend 1) elimination of the two fully-subscribed-auction bottle neck, 2) elimination of the 25% reintroduction constraint, and 3) that any unsold allowances that are forced to the price containment mechanisms go only into Reserve Tier 1.

C. Supplementary Reserve Stocking (52.4 MMt 2021-2030)

Current regulation Section 95871 Table 8-2 shows a proposed volume of 52.4 MMt of allowances to be diverted to the APCR in 2021-2030. However, AB 398 is silent on any APCR draw in the next decade. Our understanding from CARB's comments is that the APCR will be eliminated in the next decade and replaced with two Reserve tiers stocked with 81.2 MMt from the pre-2021 APCR, as previously pointed out in Section 2A above. The need for additional draw of cap volume into a reserve is now obsolete since this was conceived prior to adoption of AB 398 and its provision for unlimited allowances at the price ceiling. CARB's comment in the April 2018 "Supporting Material for Assessment of Post-2020 Caps" that the 52.4 MMt draw is to "account for the fact that 2020 emissions will be lower than the 2020 annual cap" is problematic at several levels. Firstly, the supplementary reserve acts similarly to a cap adjustment, contradicting CARB's recommendation against a cap adjustment. Secondly, emissions declines to below the cap are within the goals of SB 32 and AB 398 and a sign that the program is working. Lastly, determining that the market will not need allowances 10-12 years in the future is pure speculation. The proposed 52.4 MMt draw is excessive. Together with the 81.2 MMt diversion, they would comprise 133.6 MMt, or 50% of the average annual cap of 267.4 MM (2025) in the next decade.

Recommendation: Phillips 66 opposes the supplemental reserve stocking of 52.4 MMt of allowances from the cap to the Reserve in the next decade and recommends the 52.4 MMt be eliminated. Cap volume should be retained for regular auctions to the greatest extent possible to further assure program liquidity and cost control. The 52.4 MMt draw is now obsolete given AB 398's mandated stocking of the Reserve with 81.2 MMt.

D. Supplementary Reserve Stocking (additional 22.7 MMt 2021-2030, from 2026-2030 supply)

CARB presents an option to reserve an *additional* 22.7 MMt from the cap volume. The same arguments as above (Section 2C) can apply. Additionally, CARB's comment in the April 2018 "Supporting Material for Assessment of Post-2020 Caps" that the 22.7 MMt draw would compensate for 6% allowed offset use in 2026-2030 versus 4% in 2021-2025 per a policy decision made years ago (pre-2013) is now outdated and seems to counter the potential positive effects from higher offsets percentage. Finally, the base 40% cap decline will effectively reduce total offset use by about 40% by 2030 rendering any additional stocking of the future Reserve as regulatory overreach.

Recommendation: Phillips 66 opposes an additional 22.7 MMt draw of allowances from the cap to the Reserve. Offsets, per AB 398, should be decoupled from the Reserve.

E. Stocking of Price Ceiling Pool

AB 398 directs that allowance volume remaining in the APCR at year-end 2020 be "utilized solely for the purpose of sale at the price ceiling". Any APCR volume not sold by year-end 2020, which could be **40.6 MMt,** will be in a "pool" for sale at the price ceiling.

Recognizing the AB 398 goal of cost containment and establishment of price containment points (future Reserve), there is no need for any additional early stocking of the ceiling pool. Allowances provided under the annual cap should be retained in regular auction to the maximum extent possible.

Phillips 66 strongly supports a price ceiling design where a prompt and transparent volume of allowances is available to obligated parties. AB 398 does place an obligation on CARB to offer additional volume of emission credits at the price ceiling if needed for compliance. The workshops to date have not addressed this issue in any detail.

Recommendation: Phillips 66 opposes any additional early stocking of the ceiling pool beyond that mandated by AB 398.

Phillips supports regulations that give CARB the opportunity to secure additional emission allowances to meet demand for obligated party compliance. We support a requirement that only obligated parties be allowed to purchase from this supply and that volumes purchased be deposited only to compliance accounts. We support regulatory developments on how and when CARB would secure additional tonnes to satisfy the 1-to-1 mandate in AB 398.

3. Price Containment Points / Future Reserve Tiers

AB 398 strikes a balance in looking to the next decade of California Cap-and-Trade by maintaining previous statutory emission goals and clearly acknowledging that price containment is important. Covered entities and market participants will have greater business confidence in an environment with stable and predictable carbon market prices. Large price swings and runups would be counterproductive, could discourage covered entities from making important investment decisions, result in leakage, and threaten loss of jobs and impact the consumer. For example, a $10/tonne allowance cost translates to roughly an $0.08-0.10/gallon increase in costs for gasoline and diesel fuel, and $0.50-0.60 per thousand cubic feet increase in natural gas. Improved price control and stability will protect California consumers and the State economy from price shocks and unintended consequences such as loss of jobs and family income.

Even after accounting for complementary programs, CARB has described how the Cap-and-Trade program based on modeling must itself deliver 269-426 MMt emissions reduction by 2030. The potential for high allowance cost escalation and volatility is real. AB 398 directs 40.6 MMt allowances to each of two 2021+ "price containment points" or as previously discussed, "speedbumps" to mitigate this risk.

CARB asks for feedback on how the price containment points should be built into regulation. Phillips 66 submits that the Reserve design, sale structure and price points should be simple and transparent. These principles will help program liquidity and could be addressed in at least two ways.

CARB is considering a design with two Reserve "Tiers" that buyers could access in a similar fashion as the current APCR. AB 398 establishes that these allowances be non-tradable so the allowances would need special designation or deposited directly to compliance accounts. The price points should be transparent. Phillips 66 recommends price points as low and possible, and no higher than the 1/3 and 2/3 points between the floor price and ceiling price. Lower price points will provide better protection for the consumer.

Another option could be where CARB would release allowances back to regular auction when certain auction price triggers are reached. This could add greater liquidity to the quarterly auction process. Such allowances could need a unique designation since they are not tradable. Their clearing price could be the same as or at a modest discount to the clearing price of the regular auction volume.

Recommendation: The new "Reserve" should function in a simple and transparent way. Options include pre-identified price points as low as possible and reintroduction of the allowances to regular auction to covered entities.

4. Allocation to Industry

A. Industry Assistance Factor (AF) for 2018-2020

Leakage of both emissions and business from the State is a continuing and growing concern. As California Cap-and-Trade program costs increase for industry, leakage will likely increase as opposed to decrease as may have been assumed in the program's infancy. AB 398 recognized this and directed CARB to 1) "set industry assistance factors for allowance allocation commencing in 2021 at the levels applicable in the compliance period of 2015 to 2017" and 2) require a report to the Legislature in 2025 on "leakage risk posed by the regulation" with recommendations "on necessary statutory changes to the program to reduce leakage, including the potential for a border carbon adjustment."

Despite this recognition with respect to the latter time-period, AB 398 failed to address leakage risk in 2018-2020. The Air Resources Board recognized this in late 2017 and directed staff to similarly set the AF for industry for 2018-2020. We support CARB's recommendation to staff to designate a 1.0 AF for 2018-2020 trade assistance in regulation.

Leakage risk for California refineries continues. Other refiners in regions without Cap-and-Trade do not carry this operating cost. Refiners in other States and internationally have demonstrated their ability to produce and deliver gasoline meeting the State's stringent quality standards and deliver gasoline and diesel to other western states that are also supplied in-part by California refineries. California refineries also compete internationally for jet fuel and marine fuel sales. The California Energy Commission has commented on the complexity of this supply system as was noted in earlier comments by WSPA. Leakage is a very real phenomenon as CARB has recognized.

Recommendation: Phillips 66 supports CARB's proposal to assign an assistance factor of 1.0 for allocation to industry in 2018-2020, consistent with AB 398. We recommend that allocation reconciliation for 2018-2019 be done as soon as possible (e.g. early 2019) following rule adoption to facilitate program administration and regulatory certainty for covered entities.

B. Cap Adjustment Factor (CAF)

Phillips 66 supports CARB's determination that coke calcining meets the three criteria for receiving an alternative CAF. We thank staff for their diligent review on this issue regarding the Phillips 66 calciner and look forward to confirmation of an alternate CAF for coke calcining.

If you have any questions or need further clarification, please don't hesitate to call me at 832-765-1779.

Sincerely,

Steven D. Smith
Director, Environment, Fuels and Regulatory Affairs