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Catherine H. Reheis-Boyd
President

August 2, 2013

Via email (scliff@arb.ca.gov)

Dr. Steven Cliff
Air Resources Board
1001 I Street
Sacramento, CA 95814

RE: Comments on July 2013 Discussion Draft Proposed Amendments to Cap and Trade Regulation

Dear Dr. Cliff:

The Western States Petroleum Association (WSPA) is a trade association that represents 27 companies that explore for, develop, refine, market and transport petroleum, petroleum products and natural gas in the Western States. Many of our members operate extensively in California and have facilities that are impacted directly by the ARB's Cap and Trade Program.

In response to the workshop and the proposed revisions posted on July 15, and noting the very short period of time to prepare comments since the proposed revisions were posted, we submit the following comments on the July 2013 Discussion Draft of Proposed Amendments to ARB's Cap and Trade Regulation. We intend to submit additional comments as proposals emerge and as ARB continues the rule-making effort.

We support the staff's proposed changes to the Industry Assistance Factor and the reference to expected revisions to the Complexity Weighted Tonne (CWT) index that is currently in the regulations. We discuss the positive implications of the proposed changes below.

Industry Assistance

WSPA strongly supports the proposal to adjust the industry assistance factor in Table 8-1 of the regulation to 100% for the Second Compliance Period. WSPA also supports ARB's continued efforts to study "trade exposure" to assess possible further adjustments for the third compliance period as was discussed by staff at the July 18, 2013 workshop. We see these proposed changes as positive because an increased trade assistance factor will reduce the impact of trade exposure on facilities, help to minimize jobs leakage, and is consistent with other ARB measures to control cost.

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These benefits will, in turn, enhance stability of the cap and trade program and protect the allowance market from price volatility. Finally, these changes will minimize emissions leakage which is a key to reducing GHG emissions. We note that all the proposed benefits would occur while at the same time achieving the proposed emission reductions mandated by AB-32 and are consistent with objectives of the ARB Scoping Plan.

It is important to note that the 100% Industry Assistance Factor does not equate to 100% free allowances for all industries - there is the declining cap and then the first period “10% haircut” to the benchmark that further reduced the sector to 90% of the California refining sector average.

Some public comments were raised in the workshop about concerns regarding windfall profits. The potential for windfall profits is mitigated because allocations are based on output-based benchmarks. The sector allocation is based on the product output which is updated annually. Hence, decreasing output over the program will result in decreasing allocation. In addition, allowances are only allocated up to the cap, which declines over time.¹

Conversion of CWT-CWB

As was noted by staff at the July 18, 2013 workshop, WSPA is working with ARB staff, ARB’s consultant Ecofys and international refinery benchmarking experts Solomon Associates - original developers of the CWT and Complexity Weighted Barrel (CWB) - to modify the current regulation from CWT to CWB. WSPA strongly supports this effort to move to CWB because it is consistent with US units of measure, current equipment and processing units.

We note, for example that CWT measures in the European unit of Tonnes (mass), while CWB measures in the American unit of Barrels (volume). Amending the regulation by changing the process unit factors from CWT to CWB does not alter the outcome of the product based allocation methodology for refining. However, moving to CWB has several advantages, such as allowing the use of data more readily available to refineries while helping to ensure data quality and reliability. These factors and others, acting together, will enhance a refiner’s ability to meet the 5% MRR Product Accuracy Requirement. Adoption of the CWB factors eliminates the need for refinery modifications solely for the purpose of adding density metering that could potentially require operational disruptions. Use of the CWB index will minimize introduction of safety issues because of a diminished need to sample refinery streams that are hot and under pressure.

¹ As stated by Harvard Professor Robert Stavins in his October 2011 white paper – Economic and Environmental Implications of Allowance Allocation Benchmark Choices, “because an updating output-based allocation imposes a uniform cost on all facilities regardless of the benchmark choice, increasing or decreasing the benchmark will likely lead to (partially or fully) offsetting effects with potentially little inter-industry change in profits. On the one hand, lowering the benchmark would raise producers’ costs, thus lowering profits; on the other hand, market prices would also likely rise in response to the higher costs. Consequently, profits to individual facilities would likely remain unchanged (aside from any potential impacts due to leakage).”

The following are comments, suggestions and recommendations to improve the design, operation, implementation and cost-effectiveness of the Cap and Trade program.

Sector Equity

We note that the discussion draft proposes to amend the treatment of natural gas in regard to allowances, but does not address any amendments to the treatment of other transportation fuels. If no changes are made, then ARB would be creating serious inequities in treatment of fuel sectors. If these inequities are allowed to persist, they could result in distortions in the allowance market and adverse economic impacts to California. The Cap and Trade program should treat all forms of consumed energy (both gaseous and liquid) and energy consumers equally.

True-up Changes

WSPA objects to replacement of 95891(d)(2)(B) and 95891(d)(2)(C) with section 95891(d)(2)(B) as proposed in the discussion draft. 95891(d)(2)(B) and 95891(d)(2)(C) of the existing cap and trade regulation provide mechanisms for True Up allocations for refineries which reduce emissions to less than their initial allocation or increase emissions to greater than their baseline emissions. These sections in the existing regulation compliment the EII or efficiency based allocation methodology chosen for the first allocation period for refineries which have EII values.

95891 (d) (2) (B) applies to refineries that reduce their emissions to less than their initial allocation. These refineries would benefit directly by reducing emissions to the level of their initial allocation, but would be debited by 80% of any additional reductions. Section 95891 (d) (2) (C) applies to refineries that increase emissions to greater than their baseline allocation. These refineries would receive a percentage allocation for additional allocations based upon their distribution factor.

We note ARB's statements in the FSOR that the refinery allocation methodology for the refining sector in the first compliance period "...is appropriate and will encourage greenhouse gas efficiency in production of the primary refinery products that we (ARB) identified", and that the EII approach for complex refineries for the first compliance period "...allocates allowances based on the following factors: (1) historical emissions from each refinery, (2) the Solomon Energy Intensity Index (EII) for each refinery and (3) future emissions for each refinery." The true up mechanisms in 95891 (d) (2) (B) and 95891 (d) (2) (C) are integral to achieving the objectives of the EII approach.

WSPA supports the use of allowances issued in year "t", as a result of true up methodologies, in satisfying year "t-2" compliance obligations.

Cost Containment

In regard to cost containment, the Air Resources Board Resolution presents a significant challenge for our members; but WSPA supports the proposed amendments to address short-term cost containment in order to address market volatility and its ultimate impact on the California economy. However, WSPA encourages ARB to take further steps in the regulation to address longer term potential imbalances between supply and demand for allowances.

As outlined above, the proposal to adjust the Industry Assistance Factor is an important change that will decrease the economic impacts and increase the environmental effectiveness and integrity of the program by discouraging emissions leakage either through market shifts to imported products or

product shifts out of the state. We are encouraged that the ARB will consider extending the 100% assistance factor through the third compliance period. We believe that this review should also include economic and legislative reports - for example, use of the findings from the 2012 LAO study on carbon markets which states that the environmental goals of AB32 would not be compromised by giving free allowances to industry, as the gradual lowering of the emissions cap would still drive CO2 reductions.

WSPA also supports staff's proposal to facilitate allowance borrowing from future compliance periods if needed to increase the Allowance Price Containment Reserve (APCR). We agree that this approach can act to moderate short term price fluctuations and help promote a more smoothly functioning allowance market. However we are concerned that while the borrowing mechanism provides a good start, it ultimately is insufficient to provide the market assurance needed and does not satisfy Board Resolution 12-51, which directs staff to develop mechanisms to ensure that allowance prices do not exceed the highest price of the allowance price containment reserve.

The "borrowing" approach will certainly moderate price spikes in the near term, but would not be adequate to address the potential rise of allowance prices over the long term due to a shortage of allowances from those vintage years from which ARB 'borrowed' allowances. Without actually replacing those borrowed allowances, the market could become unstable. With economic growth and/or low supplies of offsets, the APCR could be exhausted and prices would exceed the highest tier price. WSPA suggests that ARB establish a mechanism by which it could provide new additional allowances to the market to prevent prices from exceeding the highest price in the APCR.

WSPA believes that the proposed regulation needs additional measures to address potential long term economic impacts that require cost containment and are needed to be responsive to Board Resolution 12-51. WSPA supports broader use of offsets by expanding the offset supply. Several options were discussed at the June 25th Workshop both by the panel of economic experts and in a proposal developed by the Joint Utilities Group. We believe that of the options discussed by the economic experts, adding the indirect linkage through acceptance of valid national and international offsets and allowances would provide the environmental benefits while controlling costs and potential adverse economic impact on the state's economy. WSPA also supports the removal of the offset limit, which inhibits investment in offset programs and undermines the very goal of AB32, which is the reduction of CO2 emissions.

In addition, we support expanding offsets, changing holding limits, and limited borrowing policy options described in the Joint Utility Group Cost Containment Proposals as presented in the June 25, 2013 workshop (see Attachment A). Among the offset proposals we believe that there is substantial merit to the following:

- Allowing compliance entities to carry over offsets between compliance periods
- Redistributing unused offsets back to compliance entities, and
- Improving the potential supply of eligible offset projects both geographically, as mentioned above and by changing the project commencement date.

These proposals recognize the important role offsets can play to reduce unnecessary upward pressure on allowance prices and prevent depletion of the allowance price containment reserve while meeting

the environmental goals of the program. Exposure to the high costs in the final tiers of the APCR and price volatility beyond those, will ultimately lead to emissions and jobs leakage, as companies struggle under carbon costs higher than have ever been experienced.

Holding Limits

The current holding limits 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 fact, it punishes companies who have invested more in California and rewards competitors in the same sector who have invested less.

Holding limits reduce liquidity, creating a smaller market more prone to volatility and manipulation. They stifle natural market functions to contain costs by reducing the market participant's ability to sell allowances to manage the cost exposure associated with a fluctuating carbon price. WSPA supports permitting all allowances to be held in the compliance entity's holding account including those allowances corresponding to the limited exemption.

Offsets

WSPA supports the adoption of the new protocols for Coal Mine Methane and Rice Cultivation. Allowing offsets from other geographic areas besides California provides an important cost containment mechanism for the program that is needed to keep allowance prices in control. A cost effective program is critical to prevent emissions and economic leakage of jobs to other states. Emissions and economic leakage defeats the purpose of the program and impacts the economic viability of the state.

WSPA opposes the proposed changes to the forestry offset protocol. This proposed change adds buyer liability to the forestry offset protocol. The forestry industry already has arguably the most burdensome protocol and adding a buyer liability provision will only serve to make these offsets even less desirable among obligated parties. To date, one of the chief attractions for forestry offsets has been the seller liability provision. Note that offset availability was already limited. Increasing the burdens on forestry offsets could make the offset availability in the state much more limited.

Compliance dates

WSPA does not support changing the compliance dates for mandatory reporting or for verification. It appears that this change is motivated by the need to address schedule issues introduced by providing allowances to the Natural Gas Distributors. The ARB should work with those parties separately rather than create hardship for the entire regulated community. It is already difficult to meet the verification requirements per the current regulation.

Moving up the verification deadline would add burdens to the facilities trying to secure the services of the verifiers and to the verifiers that need to complete all necessary activities prior to the deadline. With the limited number of ARB-certified verifiers to do the verification work for all reporting facilities in California, reducing the verification time could add difficulties in finding verifiers able to do

In light of these concerns, it seems clear that ARB should retain the current compliance dates.

Surrender of Compliance Instrument

WSPA opposes the proposed changes related to the surrender of compliance instruments. The provision requiring obligated parties to retire offset credits first (up to the allowed 8%) and then forfeiting any excess is extremely harmful. A company could find itself in a position where it has an excess of offsets in its compliance account either due to that company missing (under-emitting) its forecast or possibly due to an administrative error. In this case the excess offsets would be forfeited at an economic cost to the company.

WSPA also believes that this provision would discourage obligated parties from using offsets to their fullest extent because of the very severe penalties involved in being long on offsets in the compliance account. Furthermore, we do not believe that there is any reasonable scenario where this provision would increase ARB's goals of market transparency/liquidity and/or decreasing the opportunity for market manipulation. In fact, implementing this provision will have the effect of decreasing liquidity in offsets, which could increase the potential for market manipulation.

Additionally, WSPA opposes the provision requiring obligated parties to retire allowances in vintage order (oldest first). By giving the obligated party the option of which allowances/offsets to retire first, ARB is incentivizing the obligated party to behave in the most rational and economically efficient manner. Taking away this ability to choose reduces the incentive to behave economically and will reduce market efficiency. At the same time, it does nothing to promote ARB's goals of market transparency/liquidity and/or decreasing the potential for market manipulation.

Disclosure of Cap & Trade Contractors (New Section 95923)

Although WSPA understands and appreciates the need to ensure that contractors cannot misuse data gathered from the companies for whom they provide consulting support, we are concerned with the breadth of the proposed new requirement for covered entities to disclose contractors' identities and nature of their work. For example, does this include legal counsel? Would it include anyone that was engaged in the transfer of allowances to the company? Would it include those assisting in reporting requirements including entry into the CITSS system? In some cases, there may be legal requirements forbidding the disclosure of information involving the contracting organization.

WSPA recommends that more details be provided as to the extent of the proposed amendment to disclose information on cap & trade contractors. We recommend that the types of contractors that would need to be disclosed be identified specifically.

Public Information Disclosure

Public disclosure of information has been proposed for cap and trade information. WSPA is concerned with the type and amount of information that would be required and could be disclosed. We are particularly concerned about the proposal to release individual facility information. We oppose disclosure of much of this information. For example, there could be a case where a company finds itself approaching a compliance deadline and has a major short position that needs to be covered. If this information were to be made public, any potential seller that that company would approach could raise his/her prices, knowing that the company would be forced to buy. A more subtle version of this scenario would be the case where a third party is able to discover that a company has a major

short to cover and they start forcing prices up by buying instruments assuming that it will run-up even further when that company comes in to the market to buy.

We also oppose the public information sharing of names and IDs for all CITSS registrants. We are concerned about where this disclosure of information could be headed. We believe the privacy rights of these individuals should be protected.

Finally, we oppose the market data reporting provisions. We believe that these requirements will place a large and unnecessary administrative burden on companies, likely requiring additional manpower and/or systems resources. In addition, if this data is made public in some fashion which allows other market participants to “back into” that company’s net position, a third party could potentially manipulate the market to that company’s disadvantage.

In each of the public disclosures indicated above, making the net position of individual facilities public could increase the potential for market manipulation and decrease overall market liquidity.

Thank you for considering these comments. We look forward to continuing dialogue on this effort. Should you have any questions feel free to contact me or Mike Wang of my staff (cell: 626-590-4905; email: mike@wspa.org).

Regards,

A handwritten signature in blue ink, appearing to read "Cathie Boyd". The signature is fluid and cursive, with the first name "Cathie" and the last name "Boyd" clearly legible.

Cc; Eileen Hlavaka, ARB (Eileen.hlavka@arb.ca.gov)
Elizabeth, Scheehle, ARB (escheehl@arb.ca.gov)