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President

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

Subject: WSPA comments on October 2, 2015 Discussion Workshop for Cap-and-Trade Regulation 2016 Amendments.

Dear Ms. Sahota,

The Western States Petroleum Association (WSPA) appreciates the opportunity to provide comments on the issues and concepts discussed by staff at the October 2 workshop. The following comments are preliminary and reflect the fact that the workshop covered concepts for future evaluation rather than detailed subject matter. They should not be viewed as a complete accounting of our concerns with the current Cap and Trade program or our recommendations to improve the program, many of which are detailed in WSPA comment letters on previous regulatory proposals.

General Comments on ARB's 2016 Proposals

WSPA agrees with ARB's current thinking that post-2020 emission reductions should come predominantly from the Cap and Trade Program and not from "complementary measures" (slide 10). As we indicated in our October 18, 2015 comments on the state's post-2020 program planning process, complementary measures imposed by ARB tie specific sectors to anticipated progress in technology and subsequent acceptance and use by consumers, Such assumptions of progress may not, in fact, occur which will, in turn obscure the market forces and blunt changes in consumer behavior. Independent research also supports the conclusion that complementary measures are much more

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expensive than market based approaches.[1] However, even with a well-designed Cap and Trade program as the program focal point, California should condition aggressive caps on concrete actions by other jurisdictions to reduce greenhouse gas emissions. Failure to do so will shift economic productivity to other jurisdictions, resulting in job displacement and GHG emissions leakage.

ARB has indicated it would like to separate program changes necessary to facilitate continued implementation of the Cap and Trade Program from those that may be more relevant in a post-2020 program environment. However, the list of issues ARB has identified for pre-2020 amendments is lacking improvements that will be critical to minimize the potential for market volatility as the current program matures and opportunities for emission reductions are in shorter supply. Chief among these is the need to address limitations in existing cost containment mechanisms now to ensure that they are available and viable in the third compliance period. Several economists and market experts have observed in the context of California's Cap and Trade Program that it is better to address market design and cost containment issues during a period of stability than to wait for a destabilizing event to occur, at which point corrective actions may be inadequate to mitigate damage to the market, those who participate in it and the credibility of the underlying program as a model for other jurisdictions.

ARB also references its "Adaptive Management Program" as a tool to identify potential adverse localized air quality impacts from implementation of the Cap and Trade Program. While we understand that this Program will be the subject of a December Board update, we remain concerned that it has been under development for several years, yet very little Program information has been provided to the public. We are concerned ARB and the local air districts have not provided the necessary clarity on how they will use GHG emissions data to assess potential adverse impacts at the local level. This is especially a concern in light of the comprehensive network of criteria pollutant and toxic air contaminant regulations that already exist at the federal, state and local levels. As ARB is well aware, these requirements operate independently of the Cap and Trade program and will ensure continued reductions of emissions with potential localized impacts at the same facilities regulated under Cap and Trade. We need clarity on the role and operation of this program in order to participate meaningfully in the stakeholder review process.

Streamlining Offsets

WSPA maintains that the Cap and Trade regulation needs additional measures to address potential long term market imbalances that could result in allowance price spikes and unintended economic impacts. The existing suite of cost containment measures is underutilized. When any program starts there is a lag time in secondary markets, in part due to initial market stability in the absence of supply constraints. However, the regulation itself, and uncertainty and volatility created by ARB's recent amendments, interpretations and implementation actions create bottlenecks that have seriously limited the utility of these mechanisms.

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[1] *Analysis of the California ARB's Scoping Plan and Related Policy Insights*, The Charles River Associates, April 21, 2010, concludes that eliminating complementary measures from the current suite of AB 32 policies would reduce program cost by up to 50%.

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ARB's regulations governing offsets is a good example of this problem. The 8% "use it- or -lose it "quantitative use limit and its application to single compliance periods poses limitations on use of offsets. In addition, geographic restrictions, including ARB's interpretation that emission reductions outside of California are only eligible for credit if they would be considered "additional" within California, makes identifying potential offsets problematic.

Another example of how offsets availability is being limited is shown by ARB's handling of the 2014 investigation and invalidation of offsets generated from ozone depleting substance destruction projects at Clean Harbors in Arkansas. ARB's action is likely to chill development of offsets in the future, as many commenters noted in the workshops. Similarly, ARB's recent amendments to the U.S. Forest Protocol that impose new restrictions on forestry projects will make qualifying for offsets a more difficult challenge. Taken together, these and other requirements have reduced development and investment in offsets which has, in turn, constrained the pool of available offsets and their value in the marketplace.

We agree that the current offsets process would benefit from greater predictability and that actions should be taken to truncate the timeframe for issuing offset credits. However, the proposals described during ARB's October 2, 2015 workshop fall well short of the changes necessary to ensure the viability of offsets as a cost containment and leakage prevention mechanism. To achieve this outcome, ARB must also explore a range of options already identified by various market experts and compliance entities[2], including but not limited to:

- Increasing the 8% quantitative use limitation.
- Exempting California offset projects from the 8% limit.
- Allowing compliance entities to carry forward any unused portion of the 8% limit into the next compliance period.
- Redistributing unused offset "capacity" to compliance entities. For example, if usage for the prior compliance period was only 7%, ARB could allow up to 9% in the next compliance period. This approach could be implemented on an aggregate or individual compliance entity basis.
- Removing or reducing geographic use restrictions, including allowing use of offsets approved by other jurisdictions (both linked and non-linked).

ARB has often observed that the vast majority of significant emissions sources within California's borders are already controlled such that generating in-state offsets is a challenge. This challenge is not alleviated with linkage to other jurisdictions because, as noted above, emissions in those jurisdictions are only eligible for credit if they would be considered "additional" under the California program. In other words, the hurdle of finding and qualifying offsets in California is, by regulation, extended to other linked jurisdictions.

[2] See in particular the *Joint Utilities Group Cost Containment Proposals* presented during the Air Resources Board Cost Containment Workshop on June 25, 2013.

While the additionality requirement is well-founded for determining offset credit eligibility within California's borders, its applicability to emissions that occur outside of California in non-linked jurisdictions frustrates the overall intent of the program to promote GHG emission reductions on a global scale. Consider, for example, a jurisdiction with NO current GHG controls. From a global climate perspective, any emission reductions would be beneficial irrespective of whether the source would be controlled if it were located in California. However, in most cases, emission reductions from sources outside California would not be eligible for offsets under AB 32. ARB should explore how emissions reductions from those sources could be eligible under the offset program so that the effort to address global climate change can rightfully include sources around the globe.

In addition, to help restore market confidence in ARB-issued offset credits, ARB should follow Quebec's lead and create a reserve pool of credits to backfill any credits invalidated as a result of offset project investigations. In this regard, we note again that ARB's current offset investigation and invalidation process is poorly defined, at odds with existing regulatory requirements and creates extreme uncertainty in the marketplace, as has become evident in the wake of ARB's investigation of ODS destruction projects at Clean Harbors' Arkansas facility. As the International Emissions Trading Association (IETA) documents in its June 19, 2015 letter to ARB Executive Officer Richard Corey[3], this investigation has had a chilling effect on ODS project investment, and prospective purchasers of credits that could be generated under other protocols are increasingly wary of invalidation risk. If these conditions are allowed to persist, the pool of offset credits available for use in California will be grossly inadequate to meet the needs of compliance entities, increasing the potential for market volatility. Moreover, California will have sacrificed opportunities to reduce significant volumes of GHG emissions in other jurisdictions.

Additional Cost Containment Needs

In addition to the recommendations for offsets noted above, the following cost containment features should also be included in ARB's proposed amendments for the third compliance period.

1. Industry Assistance

   Looking at California's program in isolation, as the current Cap continues to decline and opportunities for emission reductions become increasingly scarce and expensive, there is a greater need for industry assistance in emissions allocation to insulate in-state companies from economic advantages that would otherwise be enjoyed by their out of state competitors. From a global perspective, the need for industry assistance in California diminishes only as other jurisdictions implement similar programs that level the playing field within regulated sectors. As ARB is aware, the response from other jurisdictions has been slow and very limited in scope. Absent an immediate groundswell of action by other jurisdictions, the reductions in industry assistance scheduled for the third compliance period will guarantee significant trade exposure for in-state regulated entities and will likely lead to emissions leakage. Thus, WSPA

[3] IETA letter to Richard Corey, *LETTER REQUESTING CLARITY ON REGULATORY COMPLIANCE, Business Summary of Impacts & Recommendations*, June 19, 2015.

recommends that ARB maintain the current 100% industry assistance factor (IAF) through the end of the second compliance period

While ARB plans to rely on the results of emissions leakage research currently underway at UC Berkeley and Resources For the Future, WSPA is very concerned that these studies, will not adequately address the refining leakage risk. We would note that the cement sector was accommodated by ARB preparing a separate leakage study.

With respect to the 3rd compliance period, WSPA understands that ARB is awaiting the results of emissions leakage research currently underway at UC Berkeley and Resources For the Future and plans to hold public workshops to identify how their findings may affect the industry assistance factor. Given the reports are not scheduled to be released until some time in 2016, any results from that work, after review, analysis, and comment by stakeholders, should be implemented as part of the 3rd compliance period that starts in 2018.

2. Price Cap

ARB's Emissions Market Assessment Committee (EMAC) previously recommended that ARB establish a maximum price at which it would sell unlimited additional allowances to avoid possible price spikes and economic dislocation from volatility in supply or demand.[4] EMAC also noted that "It is far better to have a transparent and credible process for limiting allowance prices established in advance than relying upon ad-hoc emergency measures during periods of stress."[5] Accordingly ARB should act now, in consultation with its own market experts and other program stakeholders, to establish a reasonable price cap that will help maintain market stability in the third compliance period.

3. Holding Limits

The EMAC also recommended that ARB consider relaxing current holding limit requirements to minimize the likelihood of stranding allowances. As the EMAC noted, the prohibition on transfer or sale of allowances from compliance accounts could be especially problematic for large compliance entities that choose to pre-fund their compliance accounts as a hedge against compliance risk. These entities could later find themselves flush with allowances which cannot be sold to other market participants that may be in need of additional allowances. To address this concern, the EMAC recommended that the regulations be changed to allow trading between compliance accounts, subject to certain limitations, and that this change could be accomplished "without a significant increase in the risk of market manipulation."[6] Alternatively, ARB could use the current limited exemption formula, which is scaled to an

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[4] *Price Containment in the California Cap & Trade Market*, Emissions Market Assessment Committee, November 14, 2013.

[5] *Price Ceiling in the Greenhouse Gas Emissions Cap-and-Trade Market*, Severin Borenstein, James Bushnell and Frank A. Wolak, Emissions Market Assessment Committee, November 8, 2013.

[6] *Holding Limits in California's Greenhouse Gas Emissions Cap-and-Trade Market*, Severin Borenstein, James Bushnell and Frank A. Wolak, Emissions Market Assessment Committee, November 8, 2013.

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individual entity's three year compliance obligation, to establish the holding account limit. This approach would eliminate the threat of stranding allowances.

As noted above, since the potential for market volatility is greater near the end of the market period (2020), WSPA encourages ARB to work with the EMAC and other stakeholders to adjust holding limit requirements in advance of the third compliance period.

Streamlining Auctions

ARB is requesting public input on several proposals for streamlining Cap and Trade Auctions. WSPA agrees that some of these proposals bear further consideration. Others, however, would reduce flexibility for auction participants and could discourage voluntary market participation. One such example is the suggestion to reduce options for bid guarantee mechanisms. To the contrary, all market participants would benefit from an expansion of bid guarantee options to include financial test and corporate guarantee mechanisms as are allowed under the Resource Conservation and Recovery Act (RCRA) financial assurance regulations (40 CFR Part 264/265 Subpart H). RCRA permits the owner of a hazardous waste treatment, storage, and disposal facility to use these mechanisms to prove that it has the financial means to cover closure and post-closure costs.

These RCRA financial assurance options are readily adaptable to California Cap and Trade auctions, regardless of the adequacy of the participants' in-state assets. For example, an owner/operator located outside California could use assets, credit agencies and banks within its own jurisdiction to establish that it satisfies the financial test mechanism or it could use a corporate guarantee from a parent company. Either mechanism could be submitted to ARB on an annual basis, as is required by RCRA, to cover the expected total auction procurement costs for a given auction cycle. ARB could retain this financial assurance documentation rather than having to return a bid guarantee, such as a letter of credit (LOC), for each auction. From an auction participant's perspective, LOCs and bonds are less favorable bid guarantee mechanisms because the covered entity must pay its creditors for the privilege of holding the financial instruments open for the duration of the auction process.

If a compliance entity were able to use a financial test or a corporate guarantee already on file with ARB, the Western Climate Initiative or a linked jurisdiction, that entity would be able to participate in an auction at any point in time, rather than having to wait for the next auction because it missed the window for submitting paperwork required for other financial assurance mechanisms. In addition, since the cost associated with a financial test or corporate guarantee is minimal, the compliance entity could use funds that would otherwise be dedicated to time-limited, single auction financial assurance mechanisms to purchase more allowances at auction. ARB should adapt these mechanisms from RCRA to provide auction participants a greater degree of flexibility and cost control than is currently allowed under the Cap and Trade regulations.

Auction Frequency

In response to ARB's solicitation for input on auction frequency, WSPA agrees with ARB's Emissions

Market Assessment Committee (EMAC) that "Increasing the frequency of auctions should significantly improve the credibility of the allowance price information available to market participants and the ARB."[7] The Western Climate Initiative has also asserted that more frequent auctions would reduce price volatility and opportunities for market manipulation.[8] In addition to expert opinion, ARB should look to current practice to inform the question of auction frequency. More frequent auctions are a hallmark of established emissions trading programs in other jurisdictions such as the European Union. For these reasons, ARB should consider increasing auction frequency from quarterly to monthly starting no later than the third compliance period.

Streamlining Information Management

WSPA supports ARB's proposal to allow electronic reporting and signature of required information, including attestations. We also support consolidation of corporate association disclosure requirements and changes to certain timeframes for updating required information. In particular, the current timeframes for updating registration information in section 95830(f) (1) are insufficient, especially for large corporate entities with multiple direct and indirect associations. As WSPA indicated in our October 16, 2013 comments on then-proposed changes to the Cap and Trade regulation, these timeframes should be extended to a minimum of 60 days.

In addition, to improve the clarity of the regulation and to facilitate consistent interpretations among ARB staff, verifiers and regulated entities, ARB should take this opportunity to codify its current guidance on disclosures of corporate associations and investigations of corporate affiliates, dated October 10, 2014.

Market Information / Monitoring

WSPA agrees that certain information required under the current regulation is not necessary to achieve ARB's objectives for preventing market manipulation. One example cited in WSPA's October 16, 2013 comments is the requirement for registration of "all individuals serving as Cap and Trade Consultants and Advisors for entities participating in the Cap and Trade program" in sections 95830(c)(1)(J) and 95923. It remains unclear what additional insight this information provides relative to ARB's market oversight objectives. Furthermore, as we noted in our earlier comments, it is common business practice for contracts between the company and its consultants (which often represent multiple clients) to include confidentiality provisions. This requirement is unnecessarily intrusive and violates the legal rights of entities to enter into contracts with firms of their choosing. It should be removed from the regulation.

With regard to ARB's question about whether it should release more detailed market supply measures WSPA maintains that all data pertaining to the market positions of individual entities, along with information concerning corporate associations, should be designated as confidential business

[7] *Auction Format and Auction Frequency for California's Greenhouse Gas Emissions Cap-and-Trade Market*, Severin Borenstein, James Bushnell and Frank A. Wolak, November 8, 2013.
[8] *Western Climate Initiative Markets Committee Report on Holdings Limits*, Jeffrey H. Harris, May 6, 2010.

information (CBI) by default and protected from public disclosure. Public disclosure of this information could increase the potential for market manipulation and decrease overall market liquidity. WSPA agrees that market trend analysis is important, and sufficient data to support such analysis should be publicly available. For example, ARB should report information concerning surrender of offsets for compliance purposes. However, this objective should be achieved through aggregation and de-identification of individual participant data. ARB should reach out to market participants prior to posting market data or reconfiguring existing aggregated data to ensure that it does not inadvertently disclose CBI.

Nicholas Institute "Double Cap" Concept for Post-2020 Program

WSPA opposes this approach to cap setting for post-2020 emission reductions. As we understand the concept, the first cap would be predicated on assumptions about what existing technologies can achieve by 2030. The second, more stringent cap would be aspirational, based on best-case assumptions of rapid technology innovation and widespread public adoption of transformational climate policies. The risk of failing to achieve the aspirational cap would be mitigated by creating a separate pool of allowances that would cover the difference between actual emissions reductions and the aspirational cap. This approach suffers from at least two fundamental flaws. First, setting a purely aspirational second cap necessarily implies the setting of a target based on wishes or aspirations rather than one that is based on rigorous technical and economic analysis. Second, this approach would remove additional allowances from the market, further constraining limited supplies, driving up price and effectively operating as a second "haircut" for regulated entities. Thirdly, this approach would be yet another intrusion to the market and could undermine cost containment measures that are essential to the success of a post-2020 program. For these reasons, ARB should not use the Nicholas Institute "Double Cap" concept as the model for post-2020 cap design.

Allowance Price Containment Reserve

WSPA is concerned about the growth in APCR volume and price escalation forecast under the current regulation and how this set aside may impact the market as allowances become increasingly scarce under the declining cap. One possible means of mitigating potential market volatility that could otherwise be induced by the APCR is to redistribute allowances remaining in the APCR at the end of each compliance period back into the market. WSPA looks forward to discussing this issue and the need for possible APCR reforms as ARB moves forward with this regulatory proceeding.

WSPA appreciates the opportunity to comment on ARB's proposed cap and trade concepts and look forward to continuing dialogue on this issue. Should you have any questions, feel free to contact me at this office or my staff, Mike Wang (cell: 626-90-4905; mike@wspa.org.).

Sincerely,