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Via E-Mail and FedEx

Dr. Steven Cliff
Chief, Climate Change Program Evaluation Branch
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Comments of Shell Energy North America (US), L.P. on the ARB Staff's January 31, 2014 Discussion Draft with Potential Amendments to the Cap and Trade Regulations

Dear Dr. Cliff:

Shell Energy North America (US), L.P. ("Shell Energy") provides its comments on the Staff's January 31, 2014 "Discussion Draft," in which the Staff offered potential revisions to proposed amendments to the Air Resources Board's ("ARB") Cap and Trade Regulations. Shell Energy submitted comments on October 17, 2013, in response to proposed amendments to the Regulations that were posted by the Staff on September 4, 2013. Unfortunately, upon review of the January 31, 2014 discussion draft, it appears that few, if any of Shell Energy's comments have been reflected in the updated proposed amendments.

Shell Energy reiterates in this letter many of the comments from its October 17, 2013 letter concerning specific proposed amendments to the Regulations. Shell Energy's comments focus initially, however, on two issues - - holding limits and Legacy Contracts - that apply particularly to Shell Energy and affiliated companies with which Shell Energy has a "direct corporate association" within the meaning of Section 95833.

A. <u>Holding Limits</u>

The holding limits in Section 95920 of the proposed regulations are insufficient for large emitters of greenhouse gases. The holding limits will negatively impact the ability of Shell Energy and its affiliated companies (companies with which it has a "direct corporate association") to manage their carbon costs. Shell's "holding limit" for the second compliance period (2015-2017) is approximately 11.7 MM tonnes, yet the forecasted compliance needs for Shell entities for this period exceed 40 MM tonnes. The "limited exemption" that is afforded under Section 95920(d)(2) of the proposed regulations does not help Shell to manage this issue, because once allowances are moved to the compliance account, the allowances may not be sold or traded. Effectively, the allowances are "stranded." The holding limit penalizes entities such as Shell that have a large compliance obligation.

The ARB's Emissions Market Assessment Committee ("EMAC") highlighted this issue in its November 8, 2013 report entitled "Issue Analysis: Holding Limits in California's Greenhouse Gas Emissions Cap-and-Trade Market." The report's key recommendation is to set covered entities' holding limits for allowances based on "net" holdings (holdings relative to the entity's compliance obligation). Shell Energy urges the ARB to adopt the EMAC's recommendation. This approach, which would limit the allowances in a covered entity's holding account to a reasonable level above the covered entity's compliance obligation, would help to create a level playing field between large and small compliance entities, and mitigate the current advantage enjoyed by market speculators.

B. Treatment of Legacy Contracts

The Staff's proposed changes to the cap and trade regulation would offer "transition assistance" to Legacy Contract generators in the form of "free allowances" from the CARB's reserve account. However, the language in the Staff's proposed amendments would have the effect of penalizing an entity that is a counterparty to a Legacy Contract if the entity has a "direct corporate association" (within the meaning of Section 95833) with an industrial entity receiving a direct allocation of free allowances, because the free allowances would be taken from the counterparty and given to the generator. This proposed approach effectively changes the point of regulation, but only for a subset of Legacy Contract counterparties. This approach would cause the ARB to decide, unilaterally, which party to a Legacy Contract is responsible for the cost of carbon. This approach is both arbitrary and discriminatory.

Shell Energy is a counterparty to a Legacy Contract. There is no carbon cost recovery provision in the contract. Placing the carbon cost obligation on Shell Energy essentially seizes the allowances from Shell Energy's corporate affiliate Shell Oil Company and transfers the allowances to Shell Energy's counterparty under the Legacy Contract. This approach undermines the ARB's intent to allocate free allowances to the refinery as a "trade-exposed" industry sector, and furthermore limits the refinery's use of free allowances as part of its long term GHG emissions reduction strategy. Moreover, the Staff's proposed approach would provide a competitive advantage to Legacy Contract generators that do not have a counterparty similarly situated to Shell Energy. These other Legacy Contract counterparties would receive free allowances as "transition assistance" without being subject to an adjustment.

Shell Energy is not an "Industrial Sector Legacy Contract Counterparty" within the meaning of Section 95802(a)(181) ("Definitions"), but Shell Energy would be treated as an Industrial Sector Legacy Contract Counterparty under the Staff's proposed amendments because, under Section 95891(f), Shell Energy has a "direct corporate association" with Shell Oil Company, the owner of the Martinez Refinery. Because the Martinez Refinery is eligible for a direct allocation of allowances pursuant to Section 95891(b) or (d), the Martinez Refinery would have its industrial allocation of allowances adjusted (reduced) in accordance with Section 95891(f)(1) and (2).

Section 95891(f) of the proposed regulations must be eliminated to ensure that all Legacy Contract counterparties are treated equally with respect to the allocation of free allowances attributable to emissions from generators subject to Legacy Contracts. Section 95894 of the proposed regulations properly provides for a direct allocation of free allowances to eligible Legacy Contract counterparties for "Transition Assistance." Section 95891(f) of the proposed regulations, however, has the effect of taking the free allowances away from Shell Energy, and from Shell Oil Company, which is not a party to the Legacy Contract.

In this connection, on February 10, 2014, in Docket No. R.11-03-012, CPUC Administrative Law Judge Melissa Semcer circulated a proposed decision ("PD") that recommends that the CPUC reiterate its policy to "ensure that generators [that are] party to Legacy Contracts receive compensation for their GHG costs." PD at p. 11. The PD continues:

> Absent successful renegotiation, generators that are party to Legacy Contracts, <u>regardless of whether the generator is in contract with a utility regulated by the [CPUC]</u>, should find the relief necessary to ensure GHG cost compensation through the Cap-and-Trade regulation amendment process currently underway at ARB.

<u>Id</u>. (emphasis added). In light of the intention expressed by CPUC Judge Semcer, the ARB should ensure that Legacy Contract counterparties with a compliance obligation do not lose their allocation of free allowances under the proposed regulations based on their "direct corporate associations."

Shell Energy requests that the ARB eliminate the "adjustment" under Section 95891(f) that would be made to the allowance allocation to Legacy Contract counterparties that have a direct corporate association with an entity that receives a direct allocation of allowances under Section 95891(b) or (d). Eligibility of a Legacy Contract counterparty for allocation of free allowances for Transition Assistance should stand on its own merits, without adjustment. Maintaining the same allowance eligibility for all Legacy Contract counterparties will ensure that no Legacy Contract party is discriminated against or disadvantaged in the competitive power market.

C. <u>Other Issues</u>

Shell Energy's additional comments correspond to specific sections of the proposed amendments, as follows:

1. Section 95830(c)(1)(H): The Staff's proposed amendment, which is unchanged from the September 4, 2013 version, provides that a registered entity must identify every other entity with which the registered entity has a "corporate association," a "direct corporate association," or an "indirect corporate association," as defined in Section 95833(a), whether or not the entity is registered with or intends to register with the ARB. This proposed requirement is unduly burdensome and unnecessary. The Staff has failed to justify a reporting requirement that extends significantly beyond the entities and activities that the regulations are intended to manage.

Large multi-national corporations such as Royal Dutch Shell have thousands of affiliates that would meet the definition of either a "direct" or an "indirect" corporate association. The Staff has revealed no useful purpose for disclosure all of these entities, unless the entities register with the ARB. For purposes of compliance with the Cap and Trade Regulations, it should be enough for a registered entity to identify all related entities that are "registered" with the ARB, or registered with a "linked" External Greenhouse Gas Emissions Trading System. Inquiry into a direct or indirect corporate association with an entity that is not so registered is neither appropriate nor necessary.

2. Section 95830 (c)(1)(I): This section has been modified to limit the persons to be identified (persons who are employed by the entity) to those "who have clearance from the entity to approve, initiate, or review transaction agreements, transfer requests or account balances involving compliance instruments" in the Cap and Trade program or any external "linked" program. Emphasis added. Shell Energy objects to the requirement to identify all persons who have clearance to "review" transaction agreements, transfer requests or account balances. Disclosure should be limited to persons who have authority to "approve" or "initiate" transactions.

In a large corporate organization such as Royal Dutch Shell, this proposed language, if adopted, could require disclosure of numerous individuals that are only tangentially involved in the Cap and Trade program, including individuals in foreign countries. Moreover, the Staff's failure to provide clear limits regarding the required disclosure would make it difficult to comply.

Shell Energy requests that the ARB narrow the proposed language to require disclosure of employees who have been delegated authority to commit the company to purchases and sales of compliance instruments, and who have access to the entity's CITSS account. The ARB should delete language concerning persons who have clearance to "review" transactions and transfer requests.

3. Section 95831(a)(6)(B): This section provides that if a covered entity qualifies, under Section 95870, for a direct allocation of allowances to an "annual allocation holding

account," the entity may not transfer the allowances except to its compliance account. This provision is unduly restrictive. Entities that are "long" should be allowed to sell or trade allowances, including direct allowances that are allocated under Section 95870, to entities that are "short." The ability to purchase and sell allowances is fundamental to the success of the Cap and Trade program. If the allowances allocated to an entity pursuant to Section 95870 must be transferred to a compliance account, the liquidity of the program is compromised.

4. <u>Section 95856(h)</u>: The January 31, 2014 discussion draft fails to reconsider the Staff's previous proposal to establish the "order" or "priority" in which a covered entity's compliance instruments will be retired. The proposed amendment, which would order (prioritize) the retirement of compliance instruments, is overly restrictive. The regulation should be modified to provide that the Executive Director will only dictate the order in which a covered entity's compliance instruments are to be retired if the covered entity has not otherwise designated the order in which the instruments are to be retired.

The order in which a covered entity's compliance instruments are retired should be within the discretion of the covered entity (both for its annual compliance obligation and its triennial compliance obligation), with the possible exception of "true-up" allowances, as provided in Section 95856(h)(3). The Executive Director should only prescribe the order of retirement as the "default."

Finally, the Staff solicits comments on whether there should be an 8 percent offset usage limit on the annual surrender event. Shell Energy believes that there should be no such limit on the use of offsets for annual compliance. A covered entity should be allowed to retire offsets in any proportion of its annual compliance obligation, as long as the proportion of offsets does not exceed 8 percent for the triennial compliance period.

5. <u>Section 95912(d)(4)(C), (D)</u>: The proposed amendment (which is unchanged from the September 4, 2013 version) would require a covered entity's auction participation application to include an allocation of the "purchase limit" and the "holding limit" among members of a "direct corporate association" as defined in Section 95833. Whether or not this proposed amendment is adopted, each of the covered entities with a "direct corporate association" that is subject to the purchase limit and the holding limit should be permitted to establish its own subaccount for compliance and retirement in accordance with Section 95856(c), and should be allowed to transfer compliance instruments between and among the compliance accounts for each covered entity, subject to the overall holding limits. This approach provides entities that have a direct corporate association, and that are subject to the purchase and holding limits, greater flexibility in the timing and allocation of compliance instruments for retirement. The Regulation should be amended to include a provision that allows covered entities to establish their own subaccounts for compliance and retirement.

6. Section 95912(d)(4)(E): The Staff's proposed amendment addresses the information that must be included in the "application" for auction participation. The Staff's proposed amendment would require an attestation disclosing the existence and status of any "ongoing investigation or an investigation that has occurred within the past ten years with respect to any alleged violation of any rule, regulation or law associated with any commodity, securities, or financial market" for the entity participating in the auction, "and all other entities with whom the entity has a corporate association, direct corporate association, or indirect corporate association . . . ."

This proposed amendment is overreaching and unreasonable. Under Section 95833(a)(4), an "indirect" corporate association can be established with an ownership interest that is no more than 20 percent. It is unreasonable and unduly burdensome to require the applicant to undertake the research to ascertain whether an entity with an "indirect corporate association" is the subject of an allegation of wrongdoing under financial market rules. If such a disclosure requirement is to be imposed, the requirement should be limited to entities with which the applicant has a "direct corporate association." The proposed amendment should be modified accordingly.

7. Section 95921(b)(3)(C), (4)(E,F,G), (5)(E): The Staff's proposed amendment, which is largely unchanged from the September 4, 2013 version, would require disclosure of the price term in a transfer request for the sale of compliance instruments, whether the transaction is over-the-counter or an exchange-based agreement. The Staff's proposal would require disclosure of a "fixed price" or, in the alternative, a description of the pricing method in the secondary market transaction.

There is no justification for a price disclosure requirement. Disclosure of the price of a private transaction is not supported by law. The ARB does not approve or regulate the prices of compliance instruments that are sold in secondary market transactions. The ARB also does not regulate or limit the price that an entity may charge to sell, or pay to purchase compliance instruments in the secondary market. Secondary market price regulation is outside the scope of the ARB's authority under AB 32. The ARB does not have the authority to require mandatory price disclosure as a part of a participating entity's "transfer request."

A "liquid" secondary market is dependent on a large volume of trades. Requiring price disclosure for secondary market transactions would reduce liquidity and create conditions that would make price manipulation relatively more likely.

In addition, some of the compliance instruments that will be purchased and sold in the secondary market represent "offsets," as well as allowances issued by jurisdictions (e.g., Quebec) with which the Cap and Trade program is "linked." There is a serious question whether the ARB can legally demand disclosure of prices agreed upon in offset purchase transactions that occur outside California.

Finally, because the ARB does not regulate secondary market prices for compliance instruments, no legitimate purpose would be served by having the ARB demand price disclosure as a part of a transfer request. The ARB has a valid reason for requiring the disclosure of information regarding transaction dates and the quantities transferred. Price, however, is not within the ARB's authority.

8. Section 95921(b)(3)(B), (b)(4)(C): As a part of the disclosure required for a transfer request, the Staff proposes that the parties must provide the "Agreement Transfer Date." The Staff proposes that "if there are financial or other terms related to the transfer to be settled after the transfer request is approved, the date those terms are expected to be settled must be entered as the Agreement Transfer Date."

The Staff's proposal is vague and creates considerable uncertainty. In many instances, a transfer agreement does not have a definitive end date because certain obligations (e.g., verification; auditing; true-up; providing supporting documentation) may continue for an undetermined period of time. For purposes of disclosure to the ARB, the logical "Agreement Transfer Date" is the date on which the transfer request is submitted.

9. Section 95921(b)(4)(D): The Staff proposal provides that "if the transaction agreement provides for transfers of other products," the parties must "identify the products specified in the agreement." As with the "price" provision discussed in Paragraph 7 above, the ARB does not have authority over the level of compensation or the terms of agreements unrelated to the transfer of compliance instruments. This requirement should be deleted from the proposed amendments to the regulation.

10. Section 95985(i): Under the current provision that addresses the treatment of offset credits for U.S. forest projects, the obligation to replace the ARB offset credits is on the "Forest Owner" if the offset credit is determined to be invalid after retirement of the offset. If a covered entity retires a forestry offset credit and thereafter the project is invalidated, the Forest Owner is responsible and the covered entity is still considered to be in compliance, even if it does not have enough valid compliance instruments. Entities have relied upon this provision in the negotiation and execution of contracts for the purchase of offsets, and in the allocation of costs and risks under those contracts.

The Staff proposes to amend the current Regulation. Staff proposes to shift responsibility for future "invalidation" of a forestry offset project from the Forest Owner to the covered entity if the offset was issued after July 1, 2014. The Staff's proposed modification to the Regulation, if approved, would shift the risk of project invalidation from the Forest Owner to the purchaser of the offset, regardless of the date of the contract for the purchase of the offset.

If the ARB decides to adopt the Staff's recommendation to amend this subsection, the ARB must afford "grandfathered" treatment to contracts that are entered into on or before July 1, 2014. The Staff's proposal would only "grandfather" offset credits issued to U.S. forest projects on or prior to July 1, 2014. Grandfathered treatment should apply to all pre-July 1, 2014 contracts, as well. Parties that relied upon the rules that existed at the time they entered into an agreement for the purchase and sale of forest project offsets should continue to be able to rely upon these pre-existing rules for the duration of their contract.

D. Conclusion

Shell Energy appreciates the opportunity to provide these comments on the Staff's January 31, 2014 discussion draft and Staff's proposed amendments to the Cap and Trade Regulations. If you have any questions regarding these comments, Shell Energy would be pleased to discuss the concerns raised in these comments in greater detail.

Respectfully submitted,

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