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Comments to the California Air Resources Board
From the California Independent Petroleum Association
Regarding the Proposed Cap and Trade Program Plan
Submitted June 7, 2010

The California Independent Petroleum Association respectfully submits the following comments on the Proposed Cap and Trade Program Plan.

The mission of the California Independent Petroleum Association (CIPA) is to promote greater understanding and awareness of the unique nature of California's independent oil and natural gas producer and the market place in which he or she operates; highlight the economic contributions made by California independents to local, state and national economies; foster the efficient utilization of California's petroleum resources; promote a balanced approach to resource development and environmental protection and improve business conditions for members of our industry.

CIPA appreciates the opportunity to submit the following comments to the California Air Resources Board (CARB) for its consideration. The members of CIPA believe that domestic petroleum production already plays a meaningful role in helping the state meet its policy goals for reducing green house gas emissions in California.

Moreover, CIPA and its members stand ready to do their part, to the extent practicable, to reach further reductions. But it is important to keep in mind that California oil and gas production already faces the most rigorous environmental regulation in the industry both nationally and internationally. As a result, California oil and gas production should be expanded to fully capture the environmental benefits of the regulatory regime in this state because until we have large scale alternative energy sources, California production is more environmentally sensitive than imports, and the transportation necessary to facilitate the imports, often produced with little or no environmental regulation.

On the Nature and Scope of a Cap and Trade Program

"National and international actions are necessary to fully address the issue of global warming. However, action taken by California to reduce emissions of greenhouse gases will have far-reaching effects by encouraging other states, the federal government, and other countries to act."[1]

Unfortunately, the "encouragement" has fallen far short of far-reaching. The global nature of climate means that action by California alone will do little to address the issue. Nevertheless, the situational political winds dictate the likely design and timing of climate policy at the federal and state level.

[1]Health and Safety Code §38501(d) as added by Chapter 488, Statutes of 2006.

While other regions consider their next steps, California has begun to implement policies aimed at achieving AB 32's 2020 GHG targets, with its cap-and-trade system scheduled for implementation in 2012. As a result, California will begin its cap-and-trade system without the commensurate participation it had hoped to stimulate from neighboring political subdivisions and the federal government, which in turn will have major consequences likely resulting in a range of negative economic impacts on California businesses.

It cannot be stated strongly enough: meaningful global action to limit atmospheric concentrations of GHGs can only be achieved though broad action taken across all major global economies. But in the absence of global action, an integrated market-based national policy is the most rational approach to cost-effective, meaningful emissions reductions that can overcome the adverse impacts of leakage, volatility, risk and cost. Further, an integrated market-based national program also provides the most *environmentally effective* approach to achieving GHG targets at the least economic cost because there is no opportunity for domestic emissions leakage.

Climate policy limited to California would be less environmentally effective and have greater economic impacts than comparable efforts implemented within a national cap-and-trade system or even a broad regional system if one were to actually come together with enough participants to make it meaningful and not cost prohibitive to its participants.

Given the limited likely effectiveness of a California only program, the California Independent Petroleum Association believes that it is only under a federal program that policies that can mitigate adverse economic and environmental consequences should be pursued and the current effort under way at the Air Resources Board is a costly exercise[2] that we hope will never be fully realized on the limited geographic basis currently contemplated. To do otherwise would be to embark on a mission that will yield little to the environment at great cost and disadvantage to the state's economy.

Despite the peril inherent in a California only scheme, CARB presses forward with a Cap and Trade Program. Accordingly, and with the foregoing objections to a California only scheme noted above, CIPA notes the cautionary advice from Professor Robert Stavins[3], and offers the comments on the current plan that follow:

> An important rationale in pursuing AB 32's goals was to show leadership not only with regard to the need for meaningful commitments to GHG emission reduction, but also regarding the design of effective policies to achieve these goals. Given the current hesitancy of many states, provinces and the federal government to take on such commitments, leadership on the design of California policies that achieve GHG goals while avoiding significant economic risks is all the more important. Such policies may increase the willingness of other governments to take on commitments to reducing GHG emissions, which may lead to the envisioned broad regional or national cap-and-trade systems that can achieve these goals with a lower economic impact to California and other regions' economies.[4]

On a California Only Cap and Trade Program

Western Climate Initiative

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2 CIPA members are subject to the Administrative Fee that underwrites CARB climate policy activities and therefore footing the bill for a system that we hope will never be implemented.
3 Robert N. Stavins is the Albert Pratt Professor of Business and Government, John F. Kennedy School of Government, Harvard University.
4 Todd Schatzki and Robert N. Stavins, "Next Steps for California Climate Policy II: Moving Ahead Under Uncertain Circumstances," April, 2010.

The Western Climate Initiative, comprised of seven U.S. states and four Canadian provinces, aims to cut carbon dioxide and other greenhouse gases 15 percent from 2005 levels by 2020. Its centerpiece is a cap-and-trade program enabling regulated parties to buy and sell carbon dioxide allowances.

Of the U.S. states in the initiative, only California and *maybe* New Mexico likely will be able to enforce the regional cap-and- trade program when it's due to start in 2012, along with the Canadian provinces of British Columbia, Manitoba, Ontario and Quebec. In most states and provinces, new laws must be passed before they can legally and effectively participate in the Western Climate Initiative.

Arizona and Utah have backed away from the regional cap and trade program in recent months, and legislatures in Oregon, Washington and Montana have yet to pass laws that would bring them into the planned Western carbon market. With this limited participation the program has the practical effect of being a California only program replete with huge leakage potential. As a result, CIPA strenuously objects to a rollout of cap and trade under WCI until the initiative garners the support and participation of enough member jurisdictions to make the program meaningful rather than an engine of economic and emissions leakage to neighboring states not constrained by such burdens.

Economic and Allocation Advisory Committee Report

On May 22, 2009, CARB and the Cal EPA established the Economic and Allocation Advisory Committee (EAAC). The EAAC was assigned two roles: One was to provide advice to CARB relating to its assessment of the economic impacts of the AB 32 Scoping Plan, an assessment that CIPA believes to be flawed and based upon overly optimistic expectations regarding the actual economic impacts of climate change policy as well as grossly underestimating the true economy wide consequences. The other role relates to the cap-and-trade component of the Scoping Plan. The EAAC was asked to advise CARB as to the best ways to allocate emissions allowances (emissions permits) under the cap-and-trade program.

The EAAC's recommendations were alarming, but predictable and the report we believe fails to recognize the likely economic impacts of its recommendations. Consider the following recommendation:

> ARB should rely principally, ***and perhaps exclusively***, on auctioning as a mechanism for distributing allowances (that is, for putting allowances into circulation). Auctioning is an especially transparent mechanism for allowance distribution, and it facilitates discovery of the actual costs associated with emissions abatement. It has the same potential as free allocation for achieving distributional or fairness objectives, since nearly every objective or conferral of allowance value sought through free allocation of allowances can be achieved through auctioning and the associated use of auction proceeds. In contrast with free provision, auctioning yields revenue and thereby can reduce the extent of the government's reliance on ordinary taxes for financing expenditures; this can help reduce the overall costs of AB 32. [5] (Emphasis added)

Although as if sensing how devastating their primary recommendation to be, EAAC hedged from their main recommendation with the following:

> The ARB should rely on free allocation as a distribution mechanism only where necessary to address "emissions leakage," i.e., increases in out-of-state GHG emissions generated by California's climate policy …[6].

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5 *Allocating Emissions Allowances Under a Cap and Trade Program: Recommendations to the California Air Resources Board and California Environmental Protection Agency from the Economic and Allocation Advisory Committee*, March 2010.

6 *Allocating Emissions Allowances Under a Cap and Trade Program: Recommendations to the California Air Resources Board and California Environmental Protection Agency from the Economic and Allocation Advisory Committee*, March 2010.

That emissions leakage will occur and they recognized that fact should cast doubt as to the viability of the auction recommendation on its face. But perhaps most concerning was the recommendation relative to the distribution of auction proceeds and the redistribution of allowance value. But because we believe that the auctioning of allowances will not happen at the outset of any eventual trading program we will dispense herewith a further review of the scheme to redistribute auction proceeds.

Suffice to say that CIPA sees the only value in the EAAC report to be the recognition that California businesses and the California environment will suffer from economic and emissions leakage if the eventual cap and trade program is not sufficiently large enough in geographic and economic scale.

Governor's Letter and the "New Thinking"

To his credit, Governor Schwarzenegger recognized that the EAAC had gone too far in their recommendations for market design by not recognizing the economic impact of their recommendations. Accordingly, he wrote to CARB Chairman, Mary Nichols, on March 24, 2010, warning that a transitional approach was necessary and that serious and credible attention must be paid to the important consideration of cost containment.

It has been a basic tenet of CIPA's advocacy since the passage of AB 32 that the Scoping Plan and the various AB 32 regulations incorporate cost containment mechanisms that are necessary to ensure that domestic petroleum production remain competitive for if it isn't, imports will increase from locations with far more environmental impact thus defeating the purpose of the regulation. We are encouraged by the presentation's focus on addressing cost containment and leakage concerns in the design of the cap-and-trade regulation. Avoiding leakage is also important to maintain the environmental integrity of the program.

Allowance Allocation

We appreciate the recommendation for a free allocation of allowances as an important cost containment element. We look around at the current economic output and believe that substantial reductions in emissions have been made just through reduced productivity. CIPA notes that even outside of the current economic conditions, the European Trading Scheme was rolled out with free allocation as a transition tool and that we ought not to get out ahead of the only large scale trading scheme in the world. CIPA believes that the proposed new direction outlined by CARB staff's "current thinking" reflects sensitivity to current economic problems and follows one of the important recommendations made by Governor Schwarzenegger in his letter to Chairman Nichols.

CIPA believes that staff has appropriately proposed limiting the use of an auction for allocating allowances in the early years of the program. Cost containment in the cap and trade program is critical to ensuring that oil and gas producers and all businesses for that matter in California can remain competitive because California companies will be subject to new costs not borne by competitors in other states and countries. This is particularly poignant for trade exposed industries like oil and gas production. An immediate auction for one hundred percent of allowances would impose disruptive, very high costs on the public agencies and companies subject to the program. The same concerns will remain in later compliance periods if California has not joined a comprehensive national program continuing exposure of California companies to a competitive disadvantage.

CIPA appreciates that CARB staff will be conducting in-depth analysis of covered entities by sector as part of their effort to determine an appropriate system for allocating permits and we are standing by to have the detailed conversations about the impacts on the oil and gas sector.

As we have shown throughout our oil and gas sector activities since the passage of AB 32, California production companies are much more energy efficient than out of state production, and adhere to significantly higher environmental standards than in other states and countries due to a decades-long history of high energy costs, extensive environmental regulation and aggressive energy efficiency programs in the state. This should be reflected in the establishment of an appropriate allocation strategy.

Offsets

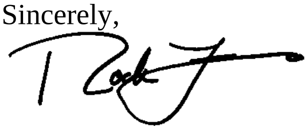
Offsets will be critical for companies that have already made significant emissions reductions and have little opportunity to reduce emissions from beyond the best available control technologies already in play. We look forward to future policy discussions with CARB staff to develop proposals to create a robust offsets market to help contain costs of the program as recommended in the Governor's letter.

We believe that strong signals today that offset projects will play a significant role in providing cost-effective emission reduction strategies to contain allowance costs for companies that want to keep jobs and expand in California are necessary to the success of the entire program. Allowing a broad use of offsets to contain costs will be very important as the total allowance budget declines in the years leading up to 2020. And unless companies who would develop offset programs understand their opportunities there could be a lack of real, verifiable offsets to fill the needs when the needs actually arise.

Timing

Finally, we believe that we are working on a very ambitious work plan to develop a program by year end. While CIPA believes that CARB is finally recognizing some of the economic realities posed by a cap and trade scheme, much needs to be done in a short amount of time. We encourage CARB to not tack toward a timeline that will hinder the development of a robust program that will have a reasonable expectation of success and to take the time necessary to get it right.

Sincerely,



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