Western States Petroleum Association
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President

December 15, 2010

Via Email

Ms. Mary Nichols, Chair
Air Resource Board
1001 I Street,
Sacramento, CA 95814

SUBJECT: Western States Petroleum Association comments Agenda 10-11-1, Public Hearing to Consider the Adoption of a Proposed California Cap on Greenhouse Gas Emissions and Market-Based Compliance Mechanisms Regulation, Including Compliance Offset Protocols.

Dear Chairwoman Nichols:

The Western States Petroleum Association (WSPA) submits the following comments on the proposed revisions to the Cap-and-Trade regulation (C&T) released on October 28, 2010 and to be considered for adoption at the December 16, 2010 Air Board hearing.

WSPA is a non-profit trade association representing twenty-eight companies that explore for, produce, refine, transport and market petroleum, petroleum products, natural gas and other energy supplies in California and five other western states. Our member companies have facilities throughout the state that will be subject to the cap-and-trade requirements in the proposed rule revisions in addition to the command and control regulations under the Federal Clean Air Act scheduled to come into effect next year.

WSPA has been an active and productive participant in policy and program issues that have evolved as a result of the passage of AB 32. For example, we have worked with you and your staff throughout this year and last year on the Low Carbon Fuel Standard (LCFS) – culminating in a well-defined Resolution at the November Board Hearing.

We believe there is consensus concerning the many unresolved issues that require further study before final ARB action. We look to the Staff and Board to convene a series of collaborative efforts throughout 2011 dedicated to gaining a better understanding of how these issues will affect the implementation of AB 32.

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A collaborative approach like the one suggested would work to ensure that AB 32 is implemented in a cost-effective and environmentally sound manner.

We have prepared below a brief description of issues we feel must be addressed before the end of 2011. The following ten issues/topics have been summarized, and specific recommendations have been provided for each:

- **Rate of Reduction in Cap (Cap Slope)**
- **Offsets**
- **Trade Exposure**
- **Holding Limits**
- **Enforcement**
- **Benchmarking**
- **Sector Equity**
- **Review Period**
- **Compliance and Documentation**
- **Fuels Under the Cap**

Rate of Reduction in Cap (Cap Slope)

The rate of reduction of the cap (cap slope) is too aggressive. The aggressive rate of reduction in the first compliance period is a particular concern because: i) ARB does not expect to have linkage with other larger GHG cap and trade programs, and ii) due to the limited protocols and administrative burdens, there will likely be a limited supply of offsets.

These factors, coupled with the aggressive rate of reduction in the early years, place unreasonable pressure on sources that are struggling to identify and implement the best and most efficient methods to reduce GHG emissions.

We understand the ARB believes that the proposed linear slope is set to achieve the 2020 goal and also achieve significant emission reductions in the short term. ARB is also expecting that the 8% offsets during the first transition period and the possibility of more offset protocols in the future will further assist in gaining emission reductions.

While WSPA understands ARB's objectives and the various compliance tools that are or may become available, we believe that the cap slope is still too strict because there is little or no linkage to other programs whether it be to the EU, WCI or other organization. For example, because California would provide the largest number of GHG facilities within WCI, we are concerned that offsets and offset protocols may not be sufficient to augment reductions at facilities.

We also have significant concerns regarding several elements that come into the cap and trade program in the second compliance period. Again, the aggressive cap slope, steep rise of allowance reserve deductions from the allowance pool, increased compliance obligations caused by ARB's finding of refining as a medium trade exposed sector, and the potential for placing transportation fuels under the cap (all scheduled to occur in the second compliance period), are likely to combine and cause adverse impacts to the economy in 2015.

To reduce the impacts from the cap design and allowance reserve deductions, we suggest that the cap be further back loaded to allow a smoother transition of 2% per year in the second compliance period, with the remaining necessary reductions delayed until California can realistically link its program in the third compliance period.

Recommendation: WSPA recommends that the ARB significantly ease the required reductions in the first compliance period, decrease to 2% the required reductions in the second compliance period and back-load more of the required emission reductions into the third compliance period.

Back-loading will: i) facilitate an orderly transition that may help achieve the emission reductions required under AB 32 and allow facilities time to implement their particular emission reduction strategies, and ii) prevent significant economic impacts until California can realistically link its program to other GHG markets. Such linkage will allow California to achieve cost effective reductions without significant economic impacts.

Finally, even with these recommended changes, the AB 32 cap is still likely to be equally or more stringent than the command and control regulations under the Federal CAA scheduled to come into effect in 2011. ARB should consider proposing that reductions under AB 32 will constitute conformance with the CAA.

Offsets

A robust offsets program is a critically important element of a cost-effective emission reduction and trading program. An effective and successful program can facilitate cost-effective GHG emission reductions from non-traditional industrial sources.

The joint WSPA-ARB collaborative in 2008 raised many key issues, some of which are described in the following paragraphs.

Offsets provide another avenue for market clearing. Rather than investing in on-site reductions, market players can buy offsets, which also serve to bring the sum of emissions and offsets into line with the supply of allowances. Thus, the availability of offsets reduces the price of carbon and increases in-cap emissions while yielding offsetting reductions outside of the cap. Through the effect on the carbon price, they may also lower leakage.

Promote innovation by allowing more flexibility in measurement of offsets

Impacts on innovation stimulated by offsets were frequently cited as a concern in developing offset policy. Offsets are a driver of innovation. This might occur through two pathways.

First, the use of offsets in uncapped sectors (e.g., agriculture and forestry in California) creates an incentive to innovate in areas that would not otherwise be reached by the carbon price signal under the cap. As emissions reductions from offsets lead to learning-by-doing, costs fall and the supply of offsets increases, providing further opportunities.

Second, offset use in developing countries might not only contribute direct emissions reductions it could also serve as a vehicle for technology transfer. The technology diffusion process, kick-started with offsets, would contribute additional emissions reductions.

Realistic approval criteria

There is a tradeoff between setting stringent approval criteria to ensure that offsets are real, additional, verifiable, etc., and the resulting offset supply. Obviously it is desirable to ensure that offsets are real and verifiable. However, the accounting and approval burden of checking could reduce the incentive to provide quality offsets as well.

Suggestions have been advanced for mitigating this problem, including a common insurance pool or other mechanism that would guarantee the performance of the total offset portfolio, in the event that individual projects underperformed.

In light of the preceding discussion, it would seem clear that offsets are an important component of compliance with AB 32. Given that the emission targets are very aggressive and require equipment that is technology-forcing, there is a danger that offsets are not in sufficient quantity to provide the needed program flexibility. For example, we note that ARB seeks only to approve four protocols at this time, when there are eleven protocols that have been developed by the Climate Action Registry,

Perhaps even a greater concern is that offset requirements appear overly prescriptive. By limiting offsets quantitatively and geographically, ARB is reducing the expected size of the offset market and thereby reducing the number of less-costly emission reduction options.

Both the lack of available protocols and the overly prescriptive ARB approval process combine to limit the amount of offsets and reduce the ability of facilities to achieve emission reductions cost-effectively.

<u>Recommendation:</u> ARB must be more aggressive in promoting the use of offsets. This would be accomplished by: i) increasing the speed at which offset protocols are adopted; ii) streamlining the process by reducing the prescriptive details of the approval process; and iii) focusing on approving independent offset approval agencies in order to reduce bottlenecks and increase the supply of offsets.

As was discussed in the Offsets Collaborative in 2008 and stated in our June 22, 2009 letter, a well-developed and flexible offsets program that leads to a robust trading system is critically important. This is especially important in the transition period where some assistance may be needed.

Two key protocols, landfill gas for North America and coal mine methane have been developed and used by the Climate Action Registry for several years. We recommend that these be considered by ARB in early 2011. The North America landfill gas protocol would add over 50% more offsets in the first compliance period. The coal mine methane protocol holds the potential to provide a large supply of valuable and verifiable offsets that could ensure that AB 32 emission reductions are achieved cost-effectively.

Specifics will need to be developed with staff as part of the on-going work in 2011.

Trade Exposure

The potential for trade exposure is a concern to all businesses and facilities that are affected by AB 32. Correct evaluation of the extent to which businesses are trade exposed is essential if AB 32 is to be implemented in a manner that will not be detrimental to the California economy.

We understand that the program designed by ARB is intended to avoid “extra allocations” and possible economic “gain” through windfall profits which appear to be key to determining how “trade exposed” an industry may be. We also recognize that ARB used some company-specific information and national and regional data (2002-2008) in their analysis.

ARB’s intention is to provide correct long-term support on leakage but the agency is open to new market analyses or new methodologies. Finally, ARB has acknowledged limitations in methodology including the fact that historic approaches and data may not be indicative of future actions.

We agree with ARB's assessment that oil and gas (crude oil) operations are highly trade exposed. However, we believe that ARB's conclusion about the refining industry as moderately trade exposed is not substantiated. In fact, given the national, international, regional, and interstate competition for petroleum products that currently exists, it is clear that the refining sector is highly trade exposed. WSPA commissioned a study by Aspen Environmental consultants to evaluate the trade exposure of the refining sector in California.

Paraphrasing from a summary, Aspen noted:

> The ARB so far has used only national level data on value added for industries by NAICS economic sectors (refining is 3241), and only international trade data for California. However, data is available at the state level for most industries, including interstate trading activity.
>
> The interstate trade exposure (TE) index for California's entire manufacturing sector is 87 percent, well beyond the 20 percent threshold that the ARB staff has proposed as "high exposure." Virtually every industrial sector exceeds the 20 percent threshold by this measure alone.
>
> Adding interstate trade to international raises the TE index for the refining sector to 26 percent. Determining the appropriate measure of trade exposure requires further exploration.
> Specific to the petroleum refining sector, the national data sources used by the ARB staff do not match with each other. The U.S. Census value of shipment and physical product appear to be 37 percent higher than the data reported by the U.S. Energy Information Administration and California Energy Commission.
> For these reasons, determining allowance allocations beyond the first cycle should be deferred until these issues can be addressed in greater detail.

<u>Recommendation:</u> ARB should convene a work group in 2011 to review the most recent economic and trade information available and determine whether ARB staff's initial conclusions are supported. WSPA is willing to commit resources to this effort, and we hope we can begin this effort promptly in the new year. We recommend that the ARB incorporate interstate trade data in their analysis[1].

<u>Holding Limits</u>

WSPA understands the theoretical concept of imposing holding limits as a way to reduce or eliminate the potential for hoarding of market allowances. However it should be clear that such limits may reduce liquidity and even inhibit efforts to achieve mandated emission reductions. As written, the proposed regulations appear to limit holdings to a fraction of the amount needed for facilities to ensure compliance.

Conversations with ARB staff indicate that the intent was to allow facilities to hold allowances in amounts at least equal to past emissions plus some ability for growth or increased production. However, the language in the proposed rule is inconsistent with the stated objective.

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[1] The ARB Staff used import/export and shipment data from the U.S. Census Bureau to measure trade activity. Interstate trade usually is much larger than foreign trade. Information on California trade from the Census Bureau is limited to the top 25 commodities imported and exported as well as the top 25 foreign trading partners. It does not track trade among states, which is the equivalent metric for the EU and Australian EITE indices. While international competition is an important component of assessing trade exposure in various California industries, it is not sufficient. California industries also face competition from industries in other states throughout the U.S. that do not face the same stringent GHG regulations or even any GHG cap at all.

ARB also needs to clarify the provisions governing holdings for associated companies. It is unclear how the regulations on individual companies may affect joint ventures or other corporate entities. In addition, some facilities must be able to hold allowances for up to 3 years due to the nature of their manufacturing or industrial processes.

Recommendation: We recommend that ARB convene a working group to develop appropriate language governing holdings and proposed holding limits.

Enforcement

In our comments on the proposed revisions to Mandatory Reporting Regulation (MRR) released October 28, 2010 [see letter dated December 15, 2010], we provide detailed comments on our concerns with the enforcement and penalty sections of the proposed revisions.

Specifically, we are concerned that the violation and penalty structure as detailed in Section 95107 of the MRR could lead to a layering of penalties such that one piece of missing or incorrect data (out of potentially millions of pieces of data) could lead to potentially massive penalties. In other words, failure to measure, collect, record and preserve data could lead to a violation and penalty for "each ton, for each day" that the alleged failure occurred.

Further as noted in sub-sections (a), (b), (c) and (d) the same "failure" regardless of the reason or circumstance could be subject to penalties under the different sections potentially leading to tripling or quadrupling of penalties for the same alleged violation.

As the mandatory reporting rule is tied to the proposed cap and trade rule, it is critical that the cap and trade rule also be addressed accordingly.

Recommendation: We urge that the adopting resolution acknowledge that this multiplication of penalties, whether in the C&T Rule or in the Monitoring Recordkeeping and Reporting (MRR) Rule, is not the intent and that ARB is committed to addressing this issue in order to make the penalty structure fair and rational.

1. **Duplicative Violation and Penalties for Insufficient Surrender of Instruments:**

   As noted in our comments on the proposed enforcement provisions to the Mandatory Reporting regulation, we have similar concerns with the enforcement provisions in the C&T Regulation. Specifically, ARB has structured the provisions such that operators that fail to surrender their compliance obligation in a timely manner are subject to a penalty requirement of four times the insufficient amount and also a separate penalty for "each day" of the violation.

   While WSPA understands ARB's need to have appropriate enforcement provisions in place to ensure compliance with meeting the requirements of the C&T Regulation, we believe imposing duplicative penalties for the same offense is unnecessarily stringent. Further, WSPA believes requiring the violator to surrender "four times the insufficient amount" could potentially penalize others in the market as it will force the early retirement of instruments that could otherwise be available for use by others in the market.

   Recommendation: WSPA recommends that the ARB revise the enforcement provisions, so that late or insufficient amount of instruments should only be subject to 1X (one times penalty). Further, we urge ARB to strongly consider all insufficient instruments that are above

1X to be surrendered in the form of a dollar payment for each instrument based on a price equal to the market price at the time the allowance should have been surrendered.

2. **Surrender Obligation Based on Unverified Emissions Report:**

   Section 95855(b) requires that covered entities surrender 30% of their obligations by May 15, based on the previous year's emissions report. As verified reports are not available until September 1, the surrender obligation would be via an unverified report. If the unverified report contains errors that are subsequently corrected, the covered entity could be liable for the penalties described above.

   <u>Recommendation</u>: WSPA recommends ARB change the deadline for annual surrender from May 15 to November 1.

   Additionally, WSPA urges ARB to work with the regulated community to develop an enforcement guidance policy. That policy should address both the C&T and MRR enforcement provisions to avoid application of duplicative penalties within and among both of the regulations. It should also recognize an operator's earnest efforts to comply, yet allow enforcement and assessment of penalties on those operators that fail to comply.

Benchmarking

The issue of benchmarking and the various methods that will be used to benchmark facility emissions is complex and in many cases breaks new ground. We recognize Staff has worked extensively to develop a feasible approach and we acknowledge their frequent outreach to the regulated community.

<u>Downstream/Refining</u>

The proposed C&T Regulation generally acknowledges that for the first compliance period WSPA has proposed a Tempered EII methodology that would allocate direct free allowances based on a facility's Solomon EII (Energy Intensity Index) metric and emissions, compared to the other sector facilities and the sector total emissions. WSPA has suggested that for the second and third compliance periods, a comprehensive, complexity-weighted methodology (yet to be developed) would be used to establish a benchmark and a basis for distribution of free allowances.

WSPA also recommends that the free allowance quantity for the sector be fixed for the first compliance period. For 2012, the free allowance quantity should be set at 100% of historical baseline emissions for the sector. Any baseline determination should recognize significant refinery expansion and configuration changes.

The historical baseline emissions should be based upon the most representative certified data from the time period 2006-2010 using defined criteria. Quantities for 2013 and 2014 would be this same amount but adjusted by the Cap Adjustment Factor.

Starting in the second compliance period, the free allowance quantity for the sector would vary according to the throughput-based benchmark calculation proposed in the regulation (S95891). The basis for the benchmark would be one that reflects refinery complexity.

WSPA will work with ARB to develop this benchmark methodology for the refining sector. A flow diagram which provides the general approach is under development. [2]

Recommendation: We understand that developing the details to implement the Tempered EII methodology will require work in early 2011. We urge that the adopting resolution acknowledge this needed work and our recommendation above.

Upstream/Oil and Gas

WSPA concurs that the upstream sector is highly trade exposed and should receive an Assistance Factor of 1.0 for all three compliance periods. We recognize the benchmarking methodology for the upstream sector in the staff proposal as a credible first step. However, other important distinctions inherent in the upstream sector including consideration of imported electricity and steam, cogeneration-related electricity/steam generation, require additional study.

Because upstream operations are highly trade exposed, we propose that the sector receive the allowances for indirect electricity use directly, as opposed to the provision of giving those allowances to the distributors. Currently the draft final rule proposes that industrial customers may receive energy efficiency programs or other indirect assistance instead of the direct rebates required to address carbon cost impacts on consumers and commercial sectors.

Direct allowance distribution to the sector will more fairly address the impacts of higher energy costs that would otherwise disadvantage this highly trade exposed sector. These allowances for imported electricity can be deducted from the utility sector to prevent double counting.

In addition, the draft final rule (appendix) may not clearly address associated gas with its level of GHG emissions. Associated gas requires considerable compression (i.e. electricity) along with gas treatment etc. If the associated gas is not included correctly along with the barrels of oil, the calculation will be in error. We will work with ARB staff to develop the correct method to benchmark for associated gas with oil production.

Recommendation: WSPA will continue to work with ARB staff to finalize an appropriate and equitable upstream sector benchmarking methodology that addresses both associated gas and other important details to ensure equitable treatment for incorporation into the C&T Regulations via a subsequent 15-day rulemaking package.

Sector Equity

It is important that any regulation treat all regulated entities impartially. The proposed regulation favors some participants and disadvantages others. For example, utilities receive 100% of their allocations first. Only thereafter are other entities given their allowances.

Regulations should avoid picking "winners and losers" and instead focus on treating all sources equitably, so that the market and public can decide the most cost-effective outcome. This need for equity covers myriad factors – from equitable use of auction funds so that no cross-subsidy occurs to equal access to the allowance market for participating facilities.

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[2] The diagram depicts the general approach and flow of necessary information to develop the Tempered EII methodology. Additional details and agreements must be developed to complete the methodology. We are committed to work together in the next six months to finalize an appropriate benchmarking approach.

Recommendation: Review the regulation to ensure that the rules are fairly structured and can be applied equitably. Remove situations where subsidies can occur or where allowances or allocations are not apportioned equitably. Ensure that fees or assessments are fairly applied.

For Combined Heat and Power (CHP), the regulation bases allocation for exported power from CHP on an assumption of carbon price recovery. The regulation must put in place provisions to monitor and ensure cost recovery. There needs to be assurance that third party CHP's serving the industrial sector receive free allocations for emissions related to the energy provided to the industrial sector on the same basis as if they were included in the sector.

Additionally, the point of regulation for Natural Gas Liquids (NGLs) should be at the point of combustion for large emitters or at the point of odorization for non-industrial use to avoid the potential for double counting or over-regulation. Any NGLs which are blended into transportation fuel should be treated in the same manner as petroleum transportation fuel.

NGLs used as feedstocks for petrochemicals are non-emissive and should be exempt from regulation. Compliance obligations for odorized propane should be delayed until 2015 to match the phase in date for local distribution companies (LDCs) and transportation fuels, since propane competes directly with natural gas in these markets.

Only odorized propane needs to have an allowance obligation and the entity with title to the propane at the point of odorization should be responsible. The PERC (Propane Education and Research Council) fee currently applies in this fashion; owners of propane at the point of odorization are known and are already paying a fee. Moving the point of regulation to large emitters, the point of odorization, and transportation fuel blenders simplifies efforts to track and cap emissions and provides transparency for the allowance market.

An additional NAICS code (211112) needs to be added to Oil and Gas Extraction Sector in Table 9-1 on A-80.[3]

Review Period

The proposed rule is very complex and there are still many unresolved issues. In fact, the uncertainty in the implementation, the possible implications on the economy, and the complex compliance requirements argue for a review period where progress and issues can be identified and addressed.

Recommendation: ARB should implement a review period at the end of the 2nd year of the first compliance period (by 1/1/14) to review the program and identify areas of concern. This review should include monitoring of key indicators using criteria developed by staff and C&T participants. The review period should conclude with a peer-reviewed report presented to ARB Board members.

Compliance and Documentation

In the past two years, in order to implement the LCFS and AB 32 Administrative Fee regulations, ARB has had to issue a series of enforcement waiver regulatory advisories because the necessary

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[3] Product Output could be a barrel of Natural Gas Liquids by Natural Gas Extraction. The Point of Regulation should be tied to the point of collection for "position holder" definition used in the excise tax laws. If the POR is not harmonized with the excise tax POR, issues could arise in the context of fuel sold via an exchange agreement (2-3 party exchanges), in-tank transfers, or terminal product purchase agreement

enabling tools were unavailable. ARB's intent in issuing these advisories was to limit enforcement exposure to companies as they complied with early provisions of the LCFS.

While we welcome ARB's action as necessary given the current regulatory tools that are (and were) available, this approach has resulted in unnecessary costs and legal uncertainties and risks. We are concerned that there is potential for similar problems under the proposed cap and trade program. We believe that reliance on enforcement waiver regulatory advisories for this regulation could result in exposure to unnecessary costs and business disruptions.

For example, if ARB does not have the registration process, auction process, tracking system or benchmarking free allocation process in place in a timely manner, we may begin the cap and trade program without being able to fully participate in the trading/auction process or without fully understanding our obligations. In many cases, these tools, guidance, and/or infrastructure are incomplete or yet to be developed.

<u>Recommendation:</u> ARB should prepare a detailed work plan of all compliance tools, guidance, and infrastructure that is necessary for entities to comply with the regulation and completion deadlines. At a minimum, the work plan should include a schedule for development of the mandatory reporting tool, training, allowance holding and compliance accounts, registration process, tracking system, auction and free allowance allocation timeline.

In addition, the work plan should specify which compliance requirements are affected by these tools, guidelines, and market infrastructure and should provide an extension period for compliance until the work plan item is fully developed.

<u>Treatment of Transportation Fuels in the Cap and Trade Program</u>

The issue of how transportation fuel emissions might be included in the state cap and trade program is critical to the ability of in-state refiners to continue to provide adequate, reliable and affordable supplies of fuel to California consumers. Given the importance of transportation fuels in the economy, it would seem prudent to fully evaluate and resolve all aspects of the impact on fuel price and availability as well as the interaction with other programs (such as the LCFS, Pavley tailpipe standards, VMT rules, etc).

This issue is magnified because in the year 2015, we would be just beginning to understand the impact of AB 32 as we enter the first year of our second compliance period As a result, few can identify with any confidence the economic impacts and energy-and environmentally-related issues that may emerge from the initial implementation of AB 32. Given our recent experience, we should take some time to evaluate how fuels could be treated within a cap-environment.

A key to developing certainty and confidence is clarity and it is lacking. Why, for example, are credits not fungible between the LCFS and C&T? Given the importance of transportation fuels in the market, it would seem prudent to evaluate and resolve this aspect of AB 32 carefully and only after extensive study.

In addition, placing fuels under the cap could also present a significant economic challenge to the state just as we hope to emerge from a recession. At a minimum, placing fuels under the cap must be avoided at least until there are widespread cap and trade programs that include fuels throughout the US and the world. [4]

Recommendation: WSPA recommends that additional study of the impacts and alternatives of how or whether to include transportation fuels emissions in the C&T program be completed before the start of the second compliance period. Prior to that time, ARB should develop a process to work with the California refining industry to evaluate all aspects, impacts and policy interactions of the treatment of transportation fuels in the AB 32 program.

Hence, WSPA recommends that fuels not be placed under the cap until: i) an additional study of the impacts and alternatives are completed; and ii) there are widespread cap and trade programs that include fuels throughout the US and the world.

Given the fact that fuel emissions make up close to 40% of the state's emission inventory, and the critical nature of fuel cost and availability to the economy of California, the state should proceed deliberately and only after careful and complete documentation of the benefits, risks, and possible economic impacts.

Thank you for reviewing our comments. We look forward to continuing our working relationship with ARB in 2011 on these important matters.

In addition, we would appreciate inclusion of a Board resolution that acknowledges the numerous unresolved issues that must be addressed in 2011, prior to moving forward with implementation of California's climate change policy in 2012.

If you have any questions, I would be happy to answer them.

Sincerely,

cc: James Goldstene
Kevin Kennedy
Ellen Peter
Will Brieger
Edie Chang
Holly Stout
Steve Cliff
Sam Wade

[4] Note: with the exception of New Zealand, none of the cap and trade programs throughout the World include fuels in the cap and trade programs. It seems reasonable to review the advantages and disadvantages of inclusion of fuels under the cap before making a final decision on how the State will proceed.