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Catherine Reheis-Boyd
President

January 20, 2017

Ms. Rajinder Sahota via e-mail at: rsahota@arb.ca.gov
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: WSPA Comments on ARB's First 15-day Package for the AB 32 Cap & Trade Regulation

Dear Ms. Sahota:

The Western States Petroleum Association (WSPA) is a non-profit trade association representing companies that explore for, produce, refine, transport and market petroleum, petroleum products, natural gas and other energy supplies in California and four other western states. WSPA appreciates this opportunity to provide comments on the Air Resources Board's (ARB) proposed 15-day changes to the Cap & Trade Regulation amendments originally noticed on August 2, 2016.

We see little in this 15-day package that is responsive to the many recommendations offered in our September 19, 2016 comments on the amendments proposed in ARB's 45-day notice of proposed rulemaking, dated August 2, 2016. In particular, we remain concerned that ARB is compounding critical program design flaws based on unrealistic assumptions about future market conditions. If ARB stays its current course, in-state Cap and Trade regulated entities would simultaneously face a steeper rate of cap decline, a shortfall in offset supply[1], increased diversion of allowances from the market into the Allowance Price Containment Reserve (APCR) and sharp reductions in allowance allocation. While the consequences of ARB's current proposals may not be apparent in the immediate future, they are likely to lead to market disruptions that will force administrative or legislative intervention, to the detriment of program environmental outcomes, regulated entities, the state economy, and the interest of other jurisdictions in following California's lead. As market experts have repeatedly observed, now is the time to mitigate these risks, not after the damage has been done.

We are also disappointed in the dialogue leading up to these proposed changes. In particular we must note statements by staff during ARB's November 7, 2016 workshop on Industry Assistance indicating that a reduction in output of up to 7.5% in any California sector is an acceptable economic loss and potential emissions leakage.[2] Staff's suggestion that economic losses approaching the levels experienced during California's recent "Great Recession" is indicative of a cavalier approach to the potential impacts of climate policies on the primary sources of middle class jobs in the California economy. As California policymakers seek to expand the reach of California's climate programs, there is an urgent need to carefully examine any

[1] *Evaluating the Potential for Sector-Based Offset Credits in California's Cap-and-Trade Program*; California Air Resources Board, October 28, 2015; Slide 12.
[2] Staff statement during ARB's *Public Workshop on the 2030 Target Scoping Plan Update: GHG Policy Scenarios, Natural & Working Lands, and Public Health Analysis,* November 7, 2016.

policies that would drive away potential partners or sacrifice opportunities to decrease costs to California consumers.

We are increasingly concerned that ARB is adopting policies that will both drive up compliance costs for regulated entities and consumers and isolate California's climate programs from the rest of the world. We ask you to explain this clear policy conflict with the Brown Administration's efforts to partner with subnational jurisdictions on climate policies to accelerate GHG emissions reductions toward achieving the ambitious international targets in the 2015 Paris Accord.

For example, ARB is contemplating a number of major, simultaneous changes to the California Cap and Trade market that could greatly increase market volatility and program cost. It is imperative that ARB consult with economic experts during the current rulemaking on the potential cumulative market impact of currently scheduled and proposed regulatory changes and adjust these program features as necessary to minimize the potential for these outcomes. These deliberations should include at a minimum: 1) the need for increased cost containment with the much more stringent 2030 cap, 2) impacts on the supply of allowances resulting from linkage to Ontario and allowing Washington State-based entities to purchase allowances from the California market, 3) streamlining the current offset process, 4) proposing additional offset protocols, 5) raising the quantitative limit on the use of offsets, 6) approving the use of sector-based offsets with a separate, incremental quantitative use limit, and 7) considering a more sophisticated price cap feature beyond the approximately $60.00/ton cap above the reserve price. Now more than ever, as we approach a steeper GHG emissions decline the state must guard against unnecessary polices that will increase compliance costs and push away rather than attract prospective partners.

WSPA recognizes that ARB feels compelled to move ahead with this early 2017 rulemaking to establish the allowance supply for 2021. That said, ARB should pursue a separate Cap and Trade rulemaking and a transparent public process later in 2017 to improve cost-containment features as a means of minimizing unwanted market volatility and unnecessary costs to California Consumers.

Since many of our market design recommendations fall within the scope of the current rulemaking, we encourage ARB to revisit our September 19 comments and address those issues either in a subsequent set of 15-day changes or in separate Cap and Trade rulemakings, as necessary.

Section 95871 and Table 8-2 - Assistance Factors for
<u>Refining, Hydrogen, Coke Calcining and Oil and Gas Production</u>

ARB's proposed adjustments to assistance factors for refining, hydrogen, coke calcining and oil and gas production are inadequate to mitigate leakage risk from these sectors in future compliance periods. ARB's proposed adjustments of post-2020 assistance factors for several sectors to account for errors in its October 21 and November 10, 2016 informal proposals, such as assumptions about percentage of energy produced on-site and sector energy intensity, underscores previously expressed concerns about the potential for multiple errors in the source data. ARB's insistence that historical trends are a reasonable predictor of future market behavior also reinforces underlying methodological flaws. This assumption denies the reality that regulated entities will make decisions based on future conditions such as carbon costs and potential direct control measures. Current market conditions are not accurate predictors of future market conditions.

While we appreciate the additional information provided in Appendix B and the Assistance Factor Calculations Spreadsheet, ARB still has not produced enough information to allow stakeholders to validate the data inputs into ARB's Assistance Factor calculations. For example, the only factor for which inputs can be independently verified for the oil and gas sector calculation is energy intensity. In this instance, ARB's source data is not suitable for application to many of California's oil and gas production operations because it uses U.S. data that significantly understates energy intensity for thermally enhanced oil production, which is unique to California.

ARB's proposed Assistance Factor "discounts" would result in billions of dollars in new costs across affected industry sectors that potentially could ripple through the statewide economy. ARB's proposals would also increase emissions leakage over time, as California-based entities continue to lose market share to competitors in lower cost jurisdictions. A loss of market share could manifest in greater exposure to lower-cost imports and increasing challenges in marketing California-made products outside of the State (e.g., gasoline and diesel to other western states, calcined coke to national markets, etc.). These dynamics would lead to greater emissions leakage.

Moreover, ARB still has not established a GHG emissions benefit that justifies its proposed Assistance Factor methodology and sector calculations. In fact, as noted in our September 19 comments, the declining cap allows the state to retain 100% Assistance Factors for regulated sectors and still achieve GHG emission reduction targets, without increasing the risk of emissions or economic leakage.

The ISOR asserts in Section L (page 15) that "The assistance factors proposed for the post-2020 period (Table 8-3 of this 15-day proposal) demonstrate that the third compliance period assistance factors are either at the level needed to prevent against emissions leakage or they are higher than needed." Yet ARB has not established the validity of its post-2020 Assistance Factor methodology and the relevance of the source data to regulated sectors. Without a valid methodology, it is not reasonable to assume that the assistance factor adjustments scheduled for the third compliance period will provide adequate protection against leakage risks.

In summary, it is unclear why ARB would risk added emissions and business leakage and put high-paying California industry jobs at risk. Without changing the industry Assistance Factors, state revenue from California will almost certainly increase over time due to: 1) the continuing allowance obligation for petroleum product, natural gas and electricity providers, and 2) the declining cap factor for industry allocation. ARB should protect California industry and not embrace policies that tip the scale in the opposite direction.

WSPA recommends that ARB retain current (second compliance period) Assistance Factor designations for all subsequent compliance periods.

<u>Section 95871 Table 8-3 – Assistance Factors by Industrial Activity</u>

ARB appears to have understated trade exposure risk for coke calcining (NAICS code 324199). The domestic AF component is understated because of the energy intensity of calcining, the high percentage of self-produced fuel, and the high emission factor associated with self-produced fuel. Because the census data utilized by ARB failed to capture the high level of exports for petroleum coke, the international AF component is also understated. A 2013 report by the Congressional Research Service documents that approximately 80% of US petroleum coke is exported.[3]

WSPA recommends that ARB work with the two operators of calciners to insure accurate characterization of their operations.

[3]Anthony Andrews and Richard K. Lattanzio, Congressional Research Service, Petroleum Coke: Industry and Environmental Issues, October 29, 2013.

Section 95891 and Table 9-2 - Cap Adjustment Factors

The cap adjustment factors proposed for certain industries with 50 percent or more process emissions and high trade exposure (e.g., nitric acid production, cement, etc.) should also be applied to hydrogen production and coke calcining. These sectors fit similar process profiles. In addition, given the subjective nature of ARB's trade exposure methodologies, it is possible that ARB has understated actual trade exposure risk for these sectors.

At a minimum, WSPA requests that ARB engage stakeholders through a workshop process to establish clear, objective criteria for which "Industrial Activities" will receive more-gradual cap adjustment factors for 2021-2031. In the interim, ARB should base eligibility for a lower rate of cap adjustment factor decline solely on the "50 percent or more process emissions" criterion.

Section 95911(g) – Disposition of Unsold Allowances

WSPA reiterates our strong opposition to ARB's August 2 proposal to transfer to the Allowance Price Containment Reserve (APCR) beginning January 1, 2018, any current vintage allowances that remain unsold for more than 24 months. This unspecified volume would be ***added*** to any unsold volumes already in the APCR (currently 141 million tons) and ***added*** to the proposed forward stocking of approximately 54 million more allowances post-2020.

The existing APCR already contains a large volume of allowances (nearly equal to the 2030 cap itself), and adding to it would only further reduce liquidity, increase uncertainty and risk of volatility for market participants and almost certainly increase future allowance cost for compliance entities. Since allowances are still available in the APCR to market participants, the most significant change is to increase the overall costs of allowances in the market by setting the price at $60 above the floor, raising costs to compliance entities without allowing the market to operate cost-effectively.

ARB's proposed interference and step-change adjustments in the market, intended to take effect less than 12 months from now constitutes a dramatic change in the regulation. It would have the effect of raising market prices in the near term, perhaps for the purpose of increasing State revenue. Further, it would have the perverse effect of rewarding some companies and penalizing others for past business decisions. Program changes, and even proposals such as this, can damage the integrity of the Cap-and-Trade program and erode confidence in the market. ARB should seek to avoid policies and actions that interfere with the current market.

In addition, ARB is proposing in these 15-day changes to use unsold allowances to cover any excess emissions created in the electricity imbalance market. WSPA objects to this policy as it would provide additional compliance cost mitigation for the electricity sector at the expense of other regulated sectors. This is another example of ARB interference in the short-term market.

WSPA continues to recommend that ARB analyze the potential for its APCR proposals to increase program costs and impact market liquidity, and allow more transparent public discussion of these issues through full 45- day notice and comment periods. Pending this review, WSPA recommends that ARB should: 1) avoid making regulatory changes that would interfere with the operation of the market in the pre-2020 timeframe, and 2) continue to return unsold allowances to auction, which will moderate expected market fluctuations without placing unreasonable new cost burdens on compliance entities.

Section 95832(f)(2) - Account Representative

The proposed 15-day language effectively requires ARB to approve any change of account representation.[4] This type of requirement adds administrative complexity, delays implementation of other program requirements and may increase compliance cost for regulated entities. The need for any such change should be clearly established in the rulemaking record, yet ARB does not provide a clear rationale for this new requirement in the ISOR for the 15-day changes (See Section D, page 6).

WSPA requests that ARB explain the basis for requiring this new agency approval.

Section 95913(d)(1)(A) - Frequency of Reserve Sales

WSPA opposes ARB's proposed changes that could reduce the frequency of Reserve sales starting in 2021. By proposing reduced future access to APCR allowances, ARB is proposing to increase the risk of market manipulation. WSPA recognizes there has been no interest in Reserve sales to date, but it is impossible to predict the extent of market volatility in the post 2020 timeframe, and therefore premature to anticipate a lack of interest in future quarterly Reserve sales.

Section 95977(c) - Verification of Sequestration Offset Projects

WSPA supports ARB's proposed change to reduce the percentage increase in Actual Onsite Carbon Stocks (from 25% to 10%) necessary to qualify a project for a verification schedule extension from 6 years to 12 years. WSPA appreciates ARB's responsiveness to stakeholder comments on this issue and encourages ARB to retain this change in the final rulemaking package.

Section 95972(c) - Offset Use Restrictions

ARB's proposal to expressly limit issuance of ARB offset credits to projects located in the United States or United States territories is based on the rationale that this clarification merely reflects the current protocol development process. ARB's current position contradicts its prior policy decision to expand the geographic scope of the program to allow for future use of offsets from North America subject to the requirements of specific protocols. It is not a clarification. Rather it signals a wholesale reversal of California's offset program policy. This limitation also serves as a deterrent to other jurisdictions seeking to participate in the California market. It is inconsistent with the reality that GHG emissions reduction is a problem to be solved at a global, not local level and is especially counterproductive in light of California's ongoing efforts to expand program linkages with Canadian provinces.

In the interest of capturing greater emissions reductions while also facilitating access to more cost-effective compliance instruments, WSPA again requests that ARB take the following actions:

- Increase the current 8% quantitative use limit to 16%, starting in the fourth compliance period.
- Expand geographic scope of offset use to include additional jurisdictions.
- Authorize the use of sector-based offsets starting in the third compliance period.
- Work with the regulated community, offset project developers and market experts on additional offset protocols and on streamlining the offset crediting process.

[4] Section 95802 defines "Accounts Administrator" as "the entity acting in the capacity to administer the accounts identified in this regulation. This may be ARB, or could be an entity ARB enters into a contract with."

WSPA recommends that ARB develop a more robust and forward thinking approach to address the very serious lack of offset supply predicted by the agency itself in the third compliance period.[5] This urgently needed offset reform and expansion should be addressed in a separate rulemaking process in early 2017. The shortfall predicted by ARB will only be exacerbated as we enter a post-2020 period characterized by a steeper cap decline and a likely higher cost environment. Based on ARB actions to date that have constrained the use of offsets and created uncertainty regarding arbitrary invalidation, the offset development community's confidence may be further dampened. The time to act on offsets is now, so that offsets will be in the pipeline in 2018 through 2030.

Section 95973(b) - Offset Invalidation

ARB's proposed language jeopardizes offset projects by granting the agency unlimited discretion to determine whether a project is out of regulatory compliance. This section simply states that the occurrence of an enforcement action by a regulatory oversight body during the Reporting Period "is not the only consideration ARB may use in determining whether a project is out of regulatory compliance." ARB offers no indication in this section or elsewhere in the regulation as to what other "considerations" may warrant a determination of project non-compliance. This vague language suggests that ARB could invalidate or deny offset credits for projects that have never received a regulatory compliance violation. It is also at cross purposes to ARB's attempts to clarify the circumstances under which an enforcement action would trigger a determination of non-compliance.

WSPA recommends that ARB make further changes to this section to specify that offset credits will not be invalidated if the primary regulatory body (e.g., EPA, OSHA, etc.) does not issue a violation pertaining to the offset project. At a minimum, the open-ended language should be removed in the next 15-day package.

In addition, forestry offset projects continue to be ineligible to receive compliance offset credits during the entire Reporting Period in the event of a violation. The impact of this invalidation risk is magnified by the above noted language under which ARB could deem any minor infraction a regulatory compliance breach, making a project ineligible for compliance offset credits for at least 6 months, even where the primary regulatory authority determines that no enforcement action is warranted. This policy appears arbitrary and punitive.

Section 95973(b) (1) and (2) – Offset Invalidation

WSPA supports ARB's amendment to limit the period for which a livestock, Mine Methane Capture (MMC) or Ozone Depleting Substance (ODS) project would be ineligible to receive offset credits for regulatory non-compliance to the precise time period during which the project was actually out of compliance, as opposed to the entire Reporting Period. This proposed change has been reflected in section 95973(b)(1); however, 95973(b)(2) excludes forestry, urban forestry and rice cultivation projects from this important regulatory update. Excluding these project types is inconsistent with previous regulatory changes that have prioritized parity between offset types, so as not to unfairly advantage one over another.

ARB's Initial Statement of Reasons for the proposed rulemaking stated that "Other project types cannot be included in this proposal because there is no quantification mechanism within the applicable protocols to identify and remove crediting of partial Reporting Periods." We must respectfully and adamantly disagree with this conclusion since credits associated with a particular period of non-compliance could be readily and accurately calculated from forestry projects. Specifically, if a forestry project was found to be out of

[5] https://www.arb.ca.gov/cc/capandtrade/meetings/102815/sector-based%20offset%20workshop%20presentation.pdf

regulatory compliance, the carbon sequestration represented in the forest growth and the wood products generated (if any) during the period of non-compliance could be subtracted from the reporting period. This can be accomplished to a high degree of accuracy by accounting for the precise growth and harvesting activities that took place during the period of non-compliance. Given this ability to quantify and remove crediting of partial Reporting Periods for forest projects, and ARB's general policy that all offset project types should be given the same regulatory treatment wherever possible, we believe forestry projects should be included with livestock, MMC and ODS in the amendment to the regulatory compliance rule.

It should also be noted that any claims of start and end dates or calculations of affected Offset Credits during a period of non-compliance would need to be "to the satisfaction of ARB," consistent with the requirement in Section 95973(b)(1).

2030 and 2050 Emissions Caps

ARB's proposed linear cap decline rate would result in a 2030 cap of 200.5 MMT with a goal of 258.6 MMT for statewide emissions. These targets appear infeasible even under the most realistic assumptions for technology penetration and consumer behavior. The proposed 2050 cap is even more speculative. Even the Energy+ Environmental Economics (E3) PATHWAYS study endorsed by ARB does not address whether the technology pathways it identifies are commercially scalable and feasible within the proposed time frame. ARB has a responsibility to design a program with feasible goals that can be implemented in a feasible time horizon. It should demonstrate that pathways exist which are technologically and economically feasible before setting enforceable caps.

WSPA recommends that ARB set caps only as far forward as it can satisfy these standards.

Section 95920(d)(2)(B) - Holding Limits

ARB's proposal to scale the Limited Exemption from the Holding Limit to the three most recent annual emissions data verification statements is effectively the same as providing a holding limit that is equal to the obligations for a full compliance period. ARB's proposed approach does not allow a regulated entity to trade Limited Exemption-qualified compliance instruments. At best this proposal offers only partial relief from current Holding Limit restrictions by allowing entities to purchase and hold what they need for the compliance period. However, it still essentially forces compliance entities to place subject compliance instruments into their compliance accounts, because those instruments cannot be traded.

WSPA recommends that ARB modify holding limit restrictions to allow any regulated entity to hold and trade an amount of allowances that is equal to its obligations for a full compliance period.

Allocation of Allowances for Purchased Electricity

WSPA would like to reiterate its support of ARB's current position, as outlined in Attachment C, to include purchased electricity in the benchmarks for industrial allocation. This direct allocation approach would establish allocation equity among facilities in a given sector regardless of their source of electricity.

WSPA recommends that ARB include new language in a subsequent set of 15-day changes to the current rulemaking to accomplish this purpose.

Section 95945(b)(2) – Retirement Only Agreements

According to the ISOR for the 45-day notice (page 254), the rationale for ARB's proposed amendment is in part "to prevent retirements for purposes of compliance with an external GHG program which California has not approved." Since WSPA member companies may have compliance obligations under multiple programs, **WSPA requests that ARB clarify how it intends to manage entities that are registered both in California and in another jurisdiction where retirement-only linkage is enabled.**

WSPA encourages ARB to revisit these comments, and the balance of our September 19, 2016 comments which do not appear to be reflected in the current 15-day package. We look forward to ARB addressing these issues in the next 15-day package or in a near-term, separate Cap and Trade rulemaking. If you have any questions, please contact me at this office, or Tiffany Roberts of my staff at (916) 325-3088 or email troberts@wspa.org.

Sincerely,

Catherine H. Reheis-Boyd

cc: Richard Corey – ARB
Edie Chang – ARB
Tiffany Roberts - WSPA