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April 22, 2019

Mr. James Duffy
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Dear Mr. Duffy,

At its workshop on April 5, California Air Resources Board (CARB) staff presented a proposal regarding potential amendments to the Low Carbon Fuel Standard's cost containment features. This letter is AJW's comment on that proposal.

We believe that the cost containment mechanism is an important provision in a LCFS, providing improved market confidence necessary to accelerate the investment in, and deployment of, low carbon fuels. The LCFS continues to be a flagship policy driving innovations in low-carbon transportation fuels and we encourage approaches that strengthen the program in ways that will deploy additional low carbon fuel investments.

While there are many ways that CARB could strengthen the current design of the Credit Clearance Mechanism (CCM), we believe the "Advance Credits" approach CARB proposed on April 5 is well thought out and will strengthen the program in multiple ways.

The CARB Proposal Would Eliminate Compliance Uncertainty in Years with a Credit Shortfall

The CARB proposal identifies a supply of additional CCM credits that will ensure the CCM is fully supplied to meet any credit shortfall for an individual fuel supplier, or for the overall market. In practice, fuel suppliers will have no reason to doubt their ability to comply with the LCFS, even in cases when their own plans for meeting their LCFS obligations are disrupted by unforeseen market or technical developments.

While the proposal eliminates compliance concerns within any given year, it may leave unaddressed some residual, but still impactful, investor concerns related to market and programmatic developments in the 5 to 10 years out timeframe. Regardless of how improbable CARB staff may regard market scenarios that would exhaust the current credit bank and the additional 10 million credits its proposed mechanism could supply into the CCM, such scenarios can be described, and will raise uncertainties and present risks in the analysis of investors. Below we suggest a possible approach to addressing this issue.

This approach also has the benefit of eliminating the prospect for fuel suppliers to have to carry forward LCFS "debts" into future years. That feature, while not unreasonable in our view, attracted significant criticism from some fuel suppliers who feared that individual company shortfalls could snowball and develop into problematic competitive disadvantages.

The Proposal Would Ensure the Economic and Environmental Integrity of LCFS

Economic – The proposed approach maintains the price signal of the LCFS market by relying on the CCM as the means by which parties with year-end deficits acquire the credits needed for compliance. This approach has the virtue of giving appropriate balance to the market power of credit sellers and credit buyers. Under the CARB proposal, market prices will tend to follow conventional supply and demand dynamics informed by a greater sense of long-term programmatic and market stability. Market participants would have far less incentive toward behaviors predicated on the regulatory risk.

Additionally, by ensuring the CCM is fully supplied to meet the demand for credits in any given year, CARB will eliminate the prospect that any deficit-generating fuel supplier would be compelled to pay prices higher than the CCM price cap to acquire LCFS credits for compliance purpose. This solidifies the effectiveness of the price cap – and correspondingly lowers or eliminates the prospects for programmatic instability that could – in the absence of a firm price cap – develop if prices were to spike as a result of supply shortfalls.

Environmental – The proposal will ensure that every credit used for compliance with the LCFS represents a real ton of reduction below the standard and reflects actual decarbonization activities. The proposal identifies unmetered use of electric vehicle recharging as the means to supply the CCM in the event that year-end deficits are greater than the credits pledged into the CCM from other fuel suppliers. This approach simply converts the timing when current electric vehicle charging activities can be converted into carbon market commodities and used for program compliance by regulated entities. This approach neither artificially creates credits, nor "borrows" reductions from anticipated future GHG reduction activities. Consequently, the proposed approach is entirely consistent with the established levels and timing of emission reductions sought by the LCFS carbon intensity targets.

The Proposed Approach Would Accelerate Investment – and Should Be Adopted by CARB

The specter – however faint – of challenges that could undermine CARB's ability to smoothly and predictably implement the LCFS creates risks that impede investment in the development and deployment of low carbon fuels. The proposal goes a long way toward addressing and eliminating those risks. CARB should initiate a regulatory process to refine, adopt, and implement its proposal as soon as possible.

Risk Assessment and LCFS Investment – The risk of market shortages in LCFS credits may seem a faint and distant prospect to many analysts. While one could make the case that the risk of meaningful shortages is small – counter arguments exist. Investors must assess the markets and arrive at their own assessment of the scale and timing of these risks. The farther out in time an assessment goes, the less confidence one can have in the assessment of the risk of credit shortfalls. As a result, the prospect for obligated parties to face future challenges regarding their ability to comply with the standard is – in most assessments – greater than a zero risk, and with uncertainties that rise over time.

Investors are obligated to anticipate potential risk, and to develop strategies to reduce their exposure to those risks they cannot mitigate or control. No single actor in the fuel market can, on their own, ensure the adequate supply of LCFS credits is available for compliance of all parties. It is an increasingly diverse market and the rate of credit or deficit generation is influenced by a variety of changeable and interrelated market forces and supply chain factors. Accordingly, no investor can be certain that a compliance shortfall is outside the realm of possibility. The result is that investors often limit their risk exposure in the LCFS market by emphasizing short-term payoff investments – reducing the prospect of stranded investments if shortages lead to program instability in the out-years.

More problematically, potential transformative investments in (and by) the petroleum sector itself have been stymied by the analysis described above. Corporate actors have limited the use of capital resources for fuel decarbonization projects as a direct result of concerns regarding long-term risk to those investments.

CARB Should Initiate a Regulatory Process to Refine and Adopt Its Proposal – We believe that the CARB proposal would create a transparent and predictable mechanism for managing compliance in the event of future LCFS credit shortfalls. Providing this clarity to the market, we believe, directly addresses – and substantially reduces – investor concerns related to the risk of programmatic instability in future years. Consequently, we would anticipate that this clarity will contribute meaningfully to the ability of investors to remove or minimize the role that potential LCFS programmatic risk plays in their analysis of fuel decarbonization investments – even those with longer-term payback profiles.

We strongly encourage CARB to initiate a rulemaking process to refine, adopt, and implement its proposal. Doing so should accelerate investments in fuel decarbonization options, increase LCFS credit availability, and create a virtuous positive feedback cycle in the market as increased supplies of low carbon fuels further solidify market confidence in the stability of the LCFS.

THE CARB PROPOSAL CAN BE IMPROVED

Identifying Additional Credit Supplies Would Be Useful – CARB has been clear and consistent in explaining that its internal data suggest that compliance shortfalls are unlikely because the volume of credit-generating fuels is expanding. While that may be entirely true, most market actors have limited access to the data CARB staff are relying on for this assessment. Furthermore, it is not unimaginable that market or technical issues could materialize in ways that are not anticipated by CARB and that reduce the volume and use of credit-generating fuels. These factors create uncertainties regarding the overall net position of LCFS credits in future years. Those uncertainties are inevitably greater as one looks farther into the future.

CARB could enhance the market-strengthening value of its proposal if it were to identify an additional quantity or source of CCM credit supply that could be tapped in the event that its proposed 10 million credit supply from unmetered electric vehicle recharging proves too small to meet future CCM demand.

This suggestion may seem unnecessary to CARB based on its public statements that the current (approx. 10 million) credit bank plus the additional 10 million CCM supply identified by this proposal are unlikely to be exhausted by CCM demand. It may further seem unnecessary to CARB because – even in the most dramatic scenarios – it would take several years to exhaust that supply of surplus credits, and CARB would have ample time to identify additional credit sources if needed.

While CARB reasoning along these lines is sound, there is still merit in identifying what may prove an entirely redundant source of additional CCM credit supply. One of the essential functions of the CCM is to eliminate the prospect that temporary shortfalls in LCFS credit supplies could create market or political instability in the program. CARB's proposal would clearly establish confidence in the program's stability for several years. Identifying an additional backup supply of CCM credits would extend that confidence out for a decade or longer. Since some of the most promising opportunities for fuel decarbonization have payback periods that stretch out 8 to 10 years, CARB can facilitate and accelerate those investments simply by identifying additional sources of CCM supply that could be tapped if needed.

As an additional benefit, taking this action could blunt criticism of the CARB proposal. We expect some stakeholders will focus on those scenarios in which a 20m credit supply will not be enough to satisfy compliance demands. Since those scenarios are necessarily predicated on opinion and conjecture, there is little CARB can do now to "prove" that such scenarios are impossible in 2025 or any other year in the future.

The best step CARB could take is to demonstrate that it has ready answers to ensuring programmatic stability regardless of what scenarios play out in the market going forward. Nothing could more powerfully focus all market actors on taking those steps that will generate the supply needed to meet the compliance needs of the LCFS than to eradicate any credible – or marginal – argument that program disruptions could lead to stranded investments in the future.

We believe identifying additional CCM supplies – though likely to be redundant – will be potent in strengthening the sense of clarity and certainty of the program and the LCFS market and will contribute meaningfully to its success in the near term.

<u>Public Reporting of Confidential Business Planning and Strategies Is Inadvisable</u> – CARB's proposal includes a suggestion that parties in need of CCM credits for compliance will be required to report to CARB the plans it has in place to achieve compliance without relying on CCM credits. It further proposes that those plans will be publicly reported. We would urge caution here and would recommend against a provision that suggest the public reporting of confidential business strategies.

We can understand the desire of CARB to ensure that obligated parties have credible plans for compliance and are taking actions to implement those plans – even if those plans are merely to acquire credits via contractual relationships with credit generators. However, the broadcasting of corporate business strategies is bound to have a chilling effect on companies to engage in activities – including long-term strategic investments – that they would not want shared publicly. It is critical for CARB to take steps that harness the competitive instincts of participants in the fuel sector to accelerate decarbonization. The majority of CARB's proposal does exactly that. We fear that the requirement to publicly disclose business plans may have the opposite effect.

Thank you for your consideration of our comments. We look forward to working with CARB staff to advance the potential amendments to the LCFS regulation.

Sincerely,

Christopher Hessler
Partner