NESTE

29 April 2019

California Air Resources Board
James Duffy
Sent via LCFSworskhop@arb.ca.gov

Re: Response to 5 April 2019 Workshop
LCFS Cost Containment

Dear Mr. Duffy:

Thank you for the opportunity to provide comments regarding the potential amendments to the cost containment features of the LCFS as discussed at the public workshop of 5 April 2019.

We write to express our disappointment in the proposed amendments. Neste was drawn to the California market based on the premise that the state would reward risk and innovation by low-carbon fuel producers who entered this market early and in volume. These proposed amendments would not just diminish incentives for innovative, large-volume, low-carbon fuel suppliers, but reward incumbent, petroleum-based fuel producers who dragged their feet in complying with the LCFS.

As you and your team are aware, Neste is the world's largest producer of renewable diesel fuel. We produce renewable diesel from a variety of renewable materials. Over the past several years, Neste has contributed to the success of the LCFS with a total approaching a billion gallons of renewable diesel from waste and residue feedstocks. Neste is one of the largest single suppliers of carbon intensity (CI) credits to California's LCFS program. Were it not for this volume of CI credits from renewable diesel in recent years, the program's current success very well could have been in question.

In addition to being the world's largest renewable diesel producer, Neste also manufactures renewable jet fuel and has plans to introduce it in commercial volumes to California. As such, Neste participates in the LCFS marketplace and is keenly interested in potential modifications to the cost containment provision that could impact liquidity and have other unintended consequences.

<u>The $200 Credit Price Should Be Re-Evaluated Based on Review of Global Demand for Renewable Fuels and the Marginal Cost of Reducing Carbon Emissions.</u>

California is a leading market and pioneer in setting targets for decarbonizing transportation fuels. But, the current credit clearance market price cap of $200 was established several years ago, before the current program's carbon reduction targets were extended and increased. At the time of setting the original price cap, there was insufficient analysis (especially considering other global markets and their respective carbon price values and caps) of an appropriate price ceiling. Considering the global competition for low carbon fuels and feedstocks, and the increasing CI reduction targets set in California, CARB needs to set a clear price signal to support its ambitious GHG targets that is adequate to

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incentivise new production and to continue to draw low-carbon fuel volumes to California in lieu of other markets.

The 2012 National LCFS Study[1] cited by Staff as one of the primary references for establishing its cost containment mechanism specifically warns against setting a price cap too low below the marginal cost of emission reductions, saying:

> Careful selection of a ceiling price is necessary to ensure the overall integrity of an LCFS program. A low price will mean the mechanism is triggered more frequently. ...

CARB's desire to institute a long-term cost containment mechanism is laudable - provided there is adequate alignment among all market participants and regulators. A price cap that is too low will disincentive good behavior and will actually serve to harm the LCFS market and prevent the overall reduction of high-carbon fuel consumption. It is important to align any price cap to fuel performance, market conditions, and the true cost of carbon emission reductions.

It is also important to remember that fuel demand - especially low carbon fuel demand - is global. The liquid fuel producers with logistic flexibility have the opportunity to supply various global markets and maximize volumes and biocriteria to the market with the most return. If California is sincerely committed to attracting adequate supplies of low carbon fuels, then it must make a more thorough evaluation of the alternative markets and the carbon prices in those markets to make a more reasoned evaluation of how California's targets and corresponding credit prices compare with those markets.

We suggest that $200 is not a leading price point when compared to other, more aggressive low-carbon markets. Continued adherence (and what appears to be increased commitment in this workshop's proposal) to this firm price cap will place California at a disadvantage in the coming years as the incremental cost of carbon emission reductions exceeds the price cap and California regulations are not flexible enough to continue to incentivise low-carbon fuels into this market.

This can most easily be seen in the price of low-carbon feedstocks. The current slate of low-carbon and sustainable feedstocks are under increasing pressure as California and other jurisdictions promote their use. This is causing continued increase in demand and corresponding price increases. One of the larger factors in determining the market price for LCFS credits is the feedstock costs. As they increase, so must the credit price.

The "Soft" Price Cap is Appropriate.

The current regulations place a cap on the credit price within the Credit Clearance Market (CCM). Staff should abandon any efforts to extend the cap to open market transactions between willing participants. If an obligated party wants to take advantage of the CCM then they can adequately be protected from excessive compliance costs. However, if an obligated party chooses to continue to participate in a credit

[1] University of California, Davis et al: "National Low Carbon Fuel Standard" July 2012.

market that exceeds the price cap for its own individual considerations, it should not be prohibited from doing so. The price cap should be a safety valve as an available option and not as an overly regulated and prescribed way of working. Staff should only promote changes to the regulations that are necessary and should otherwise let the market function efficiently without undue or overly burdensome restrictions.

Changes to Increase Cap Stringency Undermine the Investments and Progress of Low Carbon Supporters and Provide Undue Deference to Program Laggards.

CARB has consistently expressed a desire in meetings with stakeholders and in public workshops and hearings to create a stable policy and to avoid making unnecessary changes to ensure that a consistent signal is sent. However, these regulation proposals run contrary to that stated expectation.

These proposed changes are, simply, an affront to low-carbon fuel producers looking to supply long term to California. Low-carbon fuel producers have responded to the regulatory signals from the LCFS program. In making business decisions they have conducted in-depth analyses into feedstock availability, technology assessments, consumer behavior, other investments, production capacity, traditional fuel demand, and consumer preferences and trends. Based on this and many other factors, low-carbon fuel producers have made decisions to produce and supply low carbon fuels to California and are making investment decisions to grow that supply capacity. Changing the rules of the game at this stage damages the validity of the analysis and jeopardizes current and future investments and business plans.

Most of the investments and market reactions supporting the LCFS have been done by low-carbon fuel suppliers. The success to date of the LCFS has been driven by an increase in the supply and a lowering of the average carbon intensity of liquid low carbon fuels. There has not been a similar reduction in the carbon intensity or demand of traditional fuels. There has not been investment in new low-carbon fueling infrastructure or new low-carbon fuel production technologies or supply by the obligated parties. There has not been electricity infrastructure growth as fast as projected, and it is still reliant on receipt of investment support from other government grants and incentives (which is not factored in as an additional "cost" to California drivers of that low carbon solution in this analysis).

It is contrary to a strong and stable implementation of a regulation to penalize the supporters - those who are making positive steps to lower the carbon intensity and investing in growth of low carbon fuels - in favor of other market participants who are not adapting their business and operating models and then complaining that the program is not working fast enough for them. The fear exhibited by such unstable policy belies California's oft-stated goal to be a global leader and example for other markets to decarbonize transportation.

The best cure for high prices is high prices. This old adage is appropriate to consider prior to making any changes in the cost containment structure of this program. In a free market - one that reacts to regular and changing supply and demand dynamics - credit prices will not remain static. Sometimes the prices will go up and sometimes they will go down. But, the simple application of supply and demand principles will correct temporary imbalances. If a credit price rises, market participants will take actions to capture additional credits into their business operations - either by reducing the amount of high carbon fuels, or

by increasing the supplying of more low-carbon fuels. A market that is allowed to function properly will correct short-term price swings. Attempts to mitigate such blips by over-regulation are contrary to the program's stated purpose - to send clear and stable market signals to promote the decarbonization of transportation fuels.

Conclusion

The existing cost-containment provisions in place are adequate for California. The price cap in the CCM provides adequate flexibility for obligated parties to remain in compliance by limiting their costs and buying in the clearance market, or for them to complete compliance obligations by obtaining adequate credits at a free market price. CARB should abandon attempts to extend a price cap to all transactions outside of the clearance market.

Additionally, staff should refrain from attempts to install artificial regulatory solutions to increase credit supply by borrowing credits from future electricity generations. This does not accurately account for the true cost of credits when considering other State investments into electrification and inappropriately picks winners and losers - again, contrary to one of the foundational tenets of a low-carbon program.

We are happy to continue this conversation with you and your staff. Neste is committed to the long-term success of the LCFS and interested in helping to protect it from attacks by naysayers. However, we believe that these cost-containment proposals are unworkable in a well-functioning, free-market regulatory design. Please let me know if you would be interested in following up on any of these or other points.

Respectfully submitted,

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