CANTORCO2e
energy • environment • innovation

345 California Street, Suite 1260
San Francisco
CA 94104
Telephone: 415 296 9359
Facsimile: 415 296 9582
www.cantorco2e.com

December 15, 2010

Chairwoman Mary Nichols
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Comments on Proposed Cap & Trade Regulation

Chairwoman Nichols:

This letter provides comments on the October 28, 2010 proposed cap and trade program titled "Rulemaking to Consider the Adoption of a Proposed California Cap on Greenhouse Gas Emissions and Market Based Compliance Mechanisms Regulation, Including Offset Protocols" and related documents. In summary, we recommend CARB:

1. Eliminate buyer liability associated with offset reversals.
2. Eliminate the 8% cap on offset use for facility compliance.
3. Provide for the ability to carry forward/bank unused annual offset capacity.
4. Provide for the ability to use allowances and credits that result from shutdowns or curtailments.
5. Allocate allowances without charge throughout the duration of the program.

The implementation of these recommendations will:

1. Improve the prospects for achieving the ambitious goals of the AB 32.
2. Minimize compliance costs.
3. Reduce the likelihood of leakage.
4. Foster a more robust liquid emissions market.

Our recommendations are drawn from a depth and breadth of experience that is second to none. CantorCO2e is the world's oldest emissions trading brokerage firm. Established in 1992 by the global financial services firm Cantor Fitzgerald, we have played key roles in the development, implementation, and refinement of nearly every important emissions trading program in the world. In addition to providing consulting and brokerage services to our clients over the years CantorCO2e staff have served on, been a board member of, or chaired a number of emissions trading related groups including the **California Climate Change Advisory Committee** (appointed by the California Energy Commission), the **RECLAIM Three Year Audit Committee** (appointed by the South Coast Air Quality Management District), the European **Trading and Market Liquidity Group,** the **Emissions Trading Group** (a think-tank that was instrumental in shaping the European Emissions trading), the **Voluntary Carbon Standard** (an international body drawn up under the Climate Group), the **Environmental Markets Association**, and the **Ecosystems Marketplace**.

Based upon this experience we offer the following comments regarding the draft regulations:

1. **Eliminate buyer liability associated with offset reversals**. 95985(d) requires that buyers suffer sanctions or replace credits that, though approved by the CARB, later turn out to be invalid

(exceptions are provided in the event of credit invalidation owing to unintentional forest reversals per 95985(f)). Supporting documents and discussions with CARB staff suggest that CARB believes that buyers can be protected from bad credits through exhaustive due diligence, the deployment of trained verifiers, or even the use of cleverly written conveyance contracts and sophisticated derivative products. Our experience suggests that though those measures will help, they cannot (and should not) be relied upon to protect the interests of the buyer and the needs of the market.

A "buyer beware" approach will not work because it:

- Is not practical, especially in situations where a credit may be created and then sold a number of times before it is used and applied.
- Raises transaction costs. Prior to each purchase, prudent buyers will need to re-verify the credits, audit the prior evaluations of the initial verifier, and look into their crystal ball to try to determine if the CARB or some third party will (perhaps several years after their creation) challenge the credits after they are purchased and applied to a project.
- Would create two classes of separate and unequal credits – those issued by (and enjoying the full faith of) the government and those created through the offset market (which could always be undermined by some future legal challenge).
- Is not consistent with historical practice in the emission allowance, emission reduction credit, or RECLAIM Trading Credit markets.
- Is reasonable to expect CARB, which approves every offset, to stand behind the offsets that it approves.

An approach that relies upon the use of high quality credit verifiers will not work because verifiers:

- Are not officers of the government and do not have the ability to stand in CARB's shoes when it comes to determining if the credit creation activity meets the requirements of the rules as may be subsequently determined by CARB.
- Cannot (and are not paid to) monitor a project after the credits are claimed and/or transferred.
- Will, given the potential liabilities and likelihood of lawsuits (which may ensue after the credits are transferred/used), find it very challenging to secure professional liability insurance.
- Will be unable to charge a fee that adequately compensates them for the cost of doing the initial and ongoing assessments, paying for liability insurance, and setting aside cash reserves in the event that any credits which have been reviewed by the verifier are subsequently determined to be bad.

Conveyance contracts cannot be written in a fashion to remove this risk because:

- Credits may change hands many times, each time with a different buyer and seller. While demanding performance from the initial project developer may be practical it becomes quite a different prospect when the credit has been purchased numerous times before it is used and discovered to be invalid. The cascading liabilities, multiple conveyance contracts, and the passage of time that are implicit in such a scenario will make it impossible for a buyer to gain resolution in the event of bad purchases.
- The actual credits may be divided, segmented, and conglomerated into financial instruments that allow market participants to transact products that represent emission reductions from a variety of different offset creating projects. Again, it is impractical for buyers to conduct

appropriate due diligence on the offset that will make up such a derivative product. So too will it be difficult for a seller of a financial product which represents an amalgam of credits from different projects to replace just that portion that are determined to be invalid.

Nor should CARB conclude that the problem of offset reversals can be managed through the use of financial derivative products. While such products may initially reduce the risk of purchasing offsets they will, if priced considering consequential damages, sell at prices that dramatically increase transaction costs.

It is for these reasons that we recommend that CARB should:

- Stand behind determinations when it decides which credits are allowed to be used as offsets
- Hold the initial creators of the credits responsible for maintaining the reduction.
- Consider setting up an insurance pool where a small part of allowances and/or offsets are shaved off and set aside and drawn upon in the event that a reversal cannot be otherwise resolved.

2. **Eliminate the 8% cap on offset use for compliance**. 95854 and the Initial Statement of Reasons (p II-5) state that only 8% of source's compliance obligation can be satisfied with offsets. This restriction, combined with the expected use of auctions as a means to distribute the allowances, can serve to:

- Increase leakage by sources moving to less stringent regulatory regimes.
- Restrict California's ability to lead other states into participating in the cap and trade program.
- Increase compliance costs.
- Marginalize (render inconsequential) the use of offsets.
- Reduce offset usability.
  Discourage out-of-program sources that would otherwise be subject to CARB control from taking steps that would have otherwise been taken to reduce emissions.

In the end, when faced with these restrictions:

- Potential offset buyers will choose to expand – and possibly move – their operations to areas with greater offset supply (or that are not burdened with such restrictions).
- Offset creators may choose to expend their capital in markets that allow for the greater use of offsets.

We recommend that CARB remove the 8% restriction. Rather than quantitative limits, sources should be limited to using credits that meet CARB's qualitative criteria. Any credits which meet CARB's offset protocols should be useable as offsets in any amount.

3. **Provide for the ability to carry forward/bank unused annual offset capacity**. Should CARB insist on the imposition of an offset limit (whether 8% or something greater), sources should be allowed and encouraged to bank/carry forward unused offset capacity. For example, if a source has a 100,000 ton compliance obligation it would have the ability to use 8,000 tons of offsets. If the source only uses 1,000 tons of offsets we propose that the source be allowed to carry forward 7,000 tons into the subsequent years.

We also propose that the unused offset capacity be carried forward on an aggregate basis. On an annual basis, CARB should track unused, unbanked (orphaned) offset capacity from all sources.

For example, in year one CARB may determine that (market wide) 100 sources used 500,000 tons fewer than would have been allowed. Under this proposal, the 500,000 ton surplus from year one would be carried forward and allocated to all sources operating in year two. The exact distribution method (and cost) can be refined at a later date.

This proposal would serve to reduce compliance costs, encourage offset generation, while, at the same time, allow the State to meet its AB 32 emission reduction objectives.

4. **Provide for the ability to use allowances and credits that result from shutdowns or curtailments**. The regulations and supporting documents indicate that facilities may not retain (nor gain) allowances if they cease operations. This could be a logical provision - why reward facilities for revenue that can be gained from the sale of shutdown created allowances/credits? However, depriving sources of the ability to gain revenue from the shutdown of emitting units will encourage older/inefficient emitting units to stay on line. Knowing that it will forfeit its allowances and credits, a source operator will be inclined to keep the source operating as long as feasible. This will have the dual effect of discouraging equipment replacement (thereby keeping inefficient sources online) and keeping credits from the market (thereby reducing supply).

5. **Allocate allowances without charge throughout the duration of the program**. The regulations and supporting documents suggests that while sources enter the program in 2012 with free allowances it is clear that CARB's intent is to require sources to purchase an increasing quantity of credits through state sponsored auctions. We believe that doing so will unnecessarily increase the cost of the program, prompt facilities to move out of state, and render sources less able to develop and implement controls.

   Instead, CARB should utilize a simple, "free" allocation system. Under this proposal, sources are provided a declining emissions cap (or allowance checkbook). For sources in operation in 2011, the cap would be at a level that is just shy of their 2011 emissions. New sources are either given a special allocation (which may be set aside from the initial allocation) or allowed to buy surplus allowances from existing sellers.

   The logic supporting the use of free allocations (as opposed to 100% auctions) is stated below:

   - Historically, successful emissions trading programs have relied upon allowance distribution systems. Here, each source in operation at the commencement of the program is given an initial allocation that starts in year one and extends (at a declining rate) through the program's duration. We are unaware of any successful pure auction system where existing and new sources secure their initial and ongoing allowances through an auction. (Note: EPA's Acid Rain Program employs a one-time annual periodic auction, which has proven since its inception to be nothing more than an unnecessary remnant of legislative language drafted due to fear regarding price discovery and credit availability).

   - The free distribution allocation method puts tons into circulation, and rewards sources that discover they can benefit economically by reducing their allowance needs and selling their surplus. In contrast, a primary auction is another form of a carbon tax; one that delivers revenues to the government without the obligation to make prudent decisions regarding the use of such monies. For example, during rule development, RGGI received a number of comments expressing grave concern about the proper use of monies earned from the auction. Despite state and NGO dismissal of such concerns, $158 million has been diverted from climate change/mitigation activities and instead funneled to ameliorate budget deficits. There is no carbon lockbox.

- An allocation system gives sources their allocations well into the future (in some cases, indefinitely). In contrast, an auction forces participants to purchase near and long term allowances, begging the question as to how sources will recover these costs (of course, the ultimate bill is delivered to the customer who purchases the products) or finance emissions reductions. In addition, the lack of regulatory certainty wreaks havoc with capital planning by sources to install the very technologies that could achieve long term emission reductions.

- Market liquidity and diversity, will be relatively higher under a free allocation system and lower under an auction system. Giving thirty years worth of allowances to covered sources will ensure that sources have a base amount of allowances which they can either use or sell. The availability of these allowances, especially at the outset of this program, allows sources to purchase in the spot market as well as execute options, leases, swaps, and forward transactions for near term as well as future year allowances, all with variable terms and conditions and counter party credit quality.

- Government sponsored auctions cannot hope to mimic or outperform a free allocation. Withholding such allowances, and making them only available through government sponsored auctions will have an unfavorable impact on liquidity, cost to society of the program, and ultimately how great a benefit to the environment is realized. Long-term allocation also enables sources to potentially finance a portion of their capital expenditures, thus improving the return on investment for higher efficiency, lower emitting technologies.

- An auction drains cash from emitters, resulting in less available capital to invest in reducing emissions. Expecting companies to invest to reduce emissions, at the same time as paying out cash for allowances in an auction, creates a cash-crunch. The result is a reduction in investment in reducing emissions.

- An allocation gives sources the resources necessary to generate cash in the event that the holding source has found a way to reduce its greenhouse gas emissions. In contrast, an auction simply puts sources in a cost minimization mode (they do what's necessary to acquire the least amount of allowances at the outset) rather than a profit maximization mode ('over-compliance' can free up allowances that can be sold) that comes with a free allocation.

- An auction severely disadvantages existing emitters over new sources with sunk costs and stranded assets. In an auction, new entrants have the choice of tailoring their purchases and facility designs in perfect synchronization. Existing polluters have plants designed for an environment where emissions were unregulated. In contrast, new entrants have the unfair advantage of being able to design their plant for the new environment. In this way an auction discriminates against existing emitters who have a higher cost-base.

- Under an allocation system, the market (rather than the state) chooses the winners. Those who can adjust their operations in a fashion that results in fewer emissions and those who elect to purchase allowances determine which solutions advance. This is preferable to the situation where a team of well meaning government officials have a windfall of monies to spend on solutions that, by definition, are unfunded by the market.

- Finally, we thought it worth commenting on a number of instances where the European experience of 'windfall profits' in the EU Emissions Trading Scheme (EU ETS), is quoted as an illustration of why free-allocation should be avoided. This is a misunderstanding of the situation in Europe, and we deem it sufficiently important for separate comment.

In Europe, there was a small amount of over-allocation to particular industrial sectors in a small number of Member States, particularly in Eastern Europe. This was because some individual Member States were using the EU ETS as a way of providing indirect subsidies to local industry, to better enable them to compete with industry in other Member States. The European Commission caught most of these and slashed their allocations, but some slipped through.

Windfall profits from over-allocation were not material however. The material windfall profits were made in the electricity industry - the industrial sector which was universally under-allocated across Europe. Why was this? Many analysts say it was a demonstration of oligarchic market power in the European electricity industry and a failure of electricity regulation. On average, European electricity generators received free allocations amounting to around 85% of their needs and had to buy the remaining 15% on the market. What they then did was raise all of their electricity prices by 100% of the marginal purchase cost of the allowances acquired – i.e. more than six times the average cost of the allowances actually employed. So they used emissions trading as an excuse to increase prices by more than costs, and thus secure windfall profits.

How were they able to do this? Many observers say that this occurrence is the clearest demonstration in a number of years that competition in the European electricity sector is not as fierce as the generators would have you believe. Thus windfall profits in the electricity sector are an issue for electricity regulation, not emissions trading. It is important to note that the ability to increase prices by more than costs is a function of regulation and competition, and independent of whether allowances are auctioned or allocated.

CantorCO2e looks forward to receiving your feedback on this letter and to participating in future discussions with the board, its members, and staff. Please do not hesitate to call us at 415-296-9359.

Respectfully,

CANTORCO2e

Josh Margolis
CEO