

Clerk of the Board
California Air Resources Board
1001 I Street
Sacramento, California 95814

RE: Evolution Markets' Comments to the Air Resources Board on Proposed Changes to the Greenhouse Gas Cap-and-Trade and Mandatory Greenhouse Gas Reporting Regulations

August 11, 2011

Dear Sir/Madam:

Evolution Markets commends the California Air Resources Board ("ARB") on its continued progress toward the implementation of Assembly Bill 32 ("AB 32"). We welcome the opportunity to provide comments on the design of the California Cap-and-Trade Program.

Evolution Markets is a leading financial services firm providing professional brokerage and structured transaction services to participants in global environmental markets. Our Carbon Markets Brokerage Group is among the industry's largest, and through our offices in San Francisco, New York, London, and Beijing, we have been active in facilitating many of the global carbon market's pioneering transactions.

Principals at Evolution Markets have participated in market design with various international, regional, and state authorities as many of the global carbon markets underwent their formative stages. Evolution Markets' principals also have more than ten years experience facilitating emissions reduction credit (ERC) transactions in California's various air districts, as well as trades under the South Coast's RECLAIM program. Evolution Markets' representatives also served on the first WREGIS Committee, and we have had a presence on the ground in California since 2004. As such, Evolution Markets has been a consistent advocate for market-based approaches to reducing emissions in California. Our belief is that cap-and-trade programs can be an effective tool for achieving environmental goals at the lowest possible cost.

While we believe California consumers can see similar cost-containment benefits from the carbon trading program outlined in the ARB's Proposed Final Regulation, as proposed to be amended, the market must be designed in such a manner that empowers these ends. This is the focus of Evolution Markets' comments on the draft changes to the cap-and-trade regulations. Below we offer suggestions for market design that will lead to a transparent, efficient, and cost-effective program for the implementation of the ambitious greenhouse gas emission program under AB 32.

We appreciate your consideration of the following as you continue to promulgate the rules for such a program:

I. Offsets Program

A. General Comments

ARB asserts, and Evolution Markets agrees, that a robust offsets program is essential to meeting the ambitious environmental objectives of AB 32 at the lowest possible cost to the California economy.

ARB's economic analysis of the cap-and-trade program released on March 24, 2010, concluded that with offset use at the maximum allowable level a carbon allowance price of \$30 would be sufficient to achieve by 2020 the mandated carbon reductions under the AB 32 program. However in the absence of offsets, this price would be \$148 per allowance by 2020. The cost to the California economy in 2020 would be an additional \$18 billion.

Evolution Markets is concerned that the offsets program, as proposed to be amended by the ARB, could seriously limit its effectiveness in containing costs to California consumers. Rules proposed to encourage early investment in carbon offsets are administratively complex and burdensome. There could likely be a bottleneck of supply or too high a cost of issuance, which could limit the availability of early action offsets -- leading to higher compliance costs.

In addition, the ability for ARB to invalidate offset credits once issued and used for compliance -- and putting the liability of replacement on the buyer -- will likely adversely impact investment in offset projects. Compliance entities or other firms may be less willing to finance an offset project considering the unprecedented liability. This will be particularly true for small offset project developers who cannot provide a compliance guarantee for the credits they sell. This will result in fewer offset projects developed, less offset credit supply, and higher costs of compliance.

To follow are comments relating to specific elements of the ARB offsets program.

B. Early Action Offset Supply

a. Expanding the List of Eligible Early Action Credit Protocols

Carbon offsets from non-capped sectors in California's cap and trade program will be an essential cost containment mechanism available to covered entities. They will provide lower-cost emission reductions, particularly early in the program when marginal abatement costs will be high. The quality and the integrity of the carbon offset are critical to safeguard in the design of the offsets program, and because of this, quality and integrity rather than project type, should be the primary concern of the ARB.

Evolution Markets defends and advocates for well functioning, liquid markets and believes that so long as the quality and integrity of the offset is safeguarded through the application of the stringent criteria the ARB has identified for offsets, all project types meeting the ARB's regulations and the ARB's criteria should be included in the program.

Evolution Markets encourages ARB to adopt additional early action offset project protocols as expeditiously as possible to ensure adequate offsets are available at the outset of the program, as well as sufficient market liquidity. Short of ARB adopting additional protocols in 2011, Evolution Markets

strongly recommends ARB provide a short list of project types and standards that have been reviewed and are a priority for adoption.

b. Conversion of Early Action Credits

Evolution Markets understands the need by ARB to ensure all compliance offsets meet the stringent criteria defined in AB 32, including credits from early action projects. However, Evolution Markets is concerned that the complex and administratively burdensome process laid out in the proposed regulatory changes could make it more difficult to bring offsets into the system, and therefore needlessly restrict offset supply. To this end, Evolution Markets recommends streamlining the conversion process for early action projects in the following ways:

- 1.) **Allow Original Verifier to Conduct Desk Review:** Section 95990 (f.) of the proposed regulations allows for a “desk review” of early action projects for re-verification as ARB offset credits. Evolution Markets supports this important change, which will assist in streamlining the issuance process and reduce compliance costs.

However, Evolution Markets believes that requiring the desk review be conducted by an ARB-accredited verifier other than the original verifier of the project is unnecessary to maintain the integrity of the offset conversion process and presents an impediment to efficient generation of offset supply.

Evolution Markets recommends that ARB permit any ARB-accredited verifier conduct the desk review – even one that might have previously validated or verified the project in question.

- 2.) **Change the “Offset Material Misstatement” Threshold from 3% to 5%:** Section 95990(f.)(4.) stipulates that if the desk review concludes that the offset project documentation for an Offset Project Data Report year includes an “offset material misstatement” of 3% or 25,000 mtCO₂e, whichever is higher, then a full re-verification of the project is triggered. Evolution Markets believes that the 3% level will create an unnecessarily large amount of reviews, which could impede the generation of an early supply of credits.

Therefore, Evolution Markets suggests raising the threshold to 5%. This is the level at which projects may not receive Climate Reserve Tonnes from the Climate Action Reserve. Conforming these thresholds will allow ARB to maintain the environmental integrity of the program, while also eliminating unnecessary and expensive re-verifications.

- 3.) **Create Accreditation Program for Project Verifiers As Soon As Possible:** An important factor in ensuring a sufficient supply of early action credits for use in compliance will be the availability of verifiers. Evolution Markets experience in other offset markets, such as the Clean Development Mechanism (CDM) under the Kyoto Protocol, has shown that an insufficient number of verifiers can present significant delays in the development of projects and the issuance of credits.

A lack of verifiers not only has the ability to restrict supply but introduces an element of uncertainty in the timing of credit supply that has corresponding price risk for compliance buyers of offsets.

Therefore, Evolution Markets recommends ARB make the creation of the accreditation program for verifiers a priority upon the completion of this set of rule changes. Efforts to establish the accreditation program and initiate the accreditation process will allow holders of CRTs to begin the process of conversion to ARB offset credits in advance of the onset of compliance obligations, ensuring a robust early supply of offsets to be used as a cost containment mechanism.

C. Quantitative Usage Limit

As Evolution Markets has stated in previous comments to the ARB on its AB 32 regulations, the quantitative usage limit on offsets will only serve to increase the overall costs of compliance of the program. As long as offset credits are deemed by ARB to be real, permanent, and verifiable, there should be no restrictions on their use.

Not only does it increase the costs of the program, but such usage limits may also inhibit investment in offset projects. This is particularly true in those projects with long-term planning horizons, where investors may be less willing to support development of large-scale or capital intensive offset projects if there is uncertainty as to whether they will be able to monetize the carbon reduction off-take portion of the project.

This opposition to quantitative usage limits noted, Evolution Markets recognizes ARB has modified the provision to apply the limit to the triennial compliance period (or biannual compliance period for 2013-2014). This change, however, may not provide enough flexibility to compliance buyers to realize the full cost-saving potential of offsets or stimulate investment in capital intensive offset projects.

Evolution Markets recommends ARB extend the period of time to which the quantitative usage limit would apply to the full length of the program— from 2013 to 2020. The added flexibility ensures each compliance entity has an opportunity to maximize use of low-cost offsets by allowing them to invest in offset projects or purchase offset credits in the market in an efficient and risk-managed manner.

D. Invalidation of Offset Credits

In Section 95985 of the proposed rule, ARB has made several modifications and clarifications to the mechanism for the invalidation of offset credits. While Evolution Markets appreciates these changes, we continue to believe the process for invalidating offset credits and resting the liability for replacing the credits solely with the buyer introduces an unacceptable element of uncertainty to the offset market.

The result could be a reluctance of market participants to invest in offset projects and a difficulty in creating necessary liquidity in secondary offset markets, which makes low-cost offsets available to all compliance entities. In fact, Evolution Markets sees the impacts of these regulations in the market today.

As an intermediary assisting counterparty investment in offset credits, we have seen a noticeable slow down in the flow of capital to early action-eligible offset projects. The inability to complete transactions has often been directly attributable to uncertainty resulting from ARB's "buyer liability" approach. Such an approach is unprecedented in offset markets, and counterparties have not been able to address the extended risk associated with purchasing or selling offset credits. We have seen transactions break down as buyers have requested guarantees against invalidation that sellers are unwilling and unable to provide. And, we have seen investments fall through as both buyers and sellers seek to address invalidation risk post-deal confirmation.

The market activity (or lack thereof) in early action offset credits in recent months demonstrates to ARB that its assumption that market participants will be able to address the invalidation liability issue through contracts does not bear out. Furthermore, this experience should raise concern at ARB that these provisions might be having a direct impact on offset supply, and perhaps could lead to higher costs for compliance.

Evolution Markets recognizes the need for ARB to maintain the environmental integrity of the overall cap-and-trade program. We recommend ARB strongly consider the Compliance Buffer Account approach presented by the industry coalition led by the International Emissions Trading Association, or at the very least open a dialogue with industry representatives on a viable alternative.

II. Trading

Section 95921 of the proposed rules stipulate that trading counterparties must be disclosed to ARB, and all trades must be reported within three days of the transaction. Evolution Markets fully supports ARB's goal of market transparency, and its ability to monitor the trading market in order to enforce holding limits and ensure environmental compliance.

Evolution Markets welcomes changes made to Section 95921(d.) to protect confidential information. The data requested by ARB would include elements considered proprietary by market participants. Maintaining the confidentiality of this data is essential to prevent market abuses and give market participants the confidence to engage in trading, which is designed to assist them in finding the lowest cost means of compliance.

Evolution Markets also appreciates new language proposed by ARB in Section 95921(a.)(2.) in which ARB clarifies that reporting of transactions is to occur at the time of transfer of compliance instruments between holding accounts. This recognizes the difficulty in reporting all trades, and the difficulty in ARB assessing this volume of data for the purposes of market oversight and enforcing holding limits.

While Evolution Markets recognizes the need for ARB to have a mechanism to enforce holding limits and conduct market oversight, we are concerned with provisions in the revised Section 95921 that grants the ARB Executive Officer the ability to reverse transactions as a means of enforcement. This mechanism provides ARB an unprecedented enforcement power, which ultimately could be detrimental to trading liquidity and the ability for entities to hedge price risk and comply with carbon reduction targets at the lowest possible cost.

Reversing commercial transactions between counterparties creates a host of contractual and compliance issues. The foundation of a properly functioning market is that commercial contracts between counterparties cannot be unwound. An obligation to sell allowances to another counterparty must be met, and once the transfer of allowances and cash has taken place counterparties cannot be expected to reverse this transaction.

To create the possibility of a transaction reversal would introduce an unacceptable measure of risk to carbon transactions. Sellers would be exposed to undue price risk in the interim between the transaction, the transfer, and the potential reversal. As a result, a reversal might present market risk that impedes implementation of hedging strategies.

Furthermore, such reversals may create a daisy chain of violations of holding limit provisions. In the instance of ARB reversing a transaction, the buyer of allowances will return the allowances to the seller. The seller may have sold the allowances to ensure it did not violate its own holding limits, and the return of allowances from the reversed transaction might then put the seller over its holding limit. This would, in turn, generate another series of reversals which would impact still other counterparties.

Importantly, a seller will have no insight into the holdings of the buyer, and therefore should not be responsible for returning cash to the buyer and taking back allowances in instances where the seller is over the proposed holding limit, for instance.

Evolution Markets believes ARB should consider an alternative enforcement mechanism that focuses solely on the responsible party. Rather than reverse transactions, which could have unintended negative consequences for multiple market participants, Evolution Markets recommends taking punitive action against the entity in violation. In the case of holding limits, this might include providing the entity a set period of time to dispense of excess allowances, whether in the market, through bi-lateral transfers, or other means. Evolution Markets would welcome an opportunity to further discuss with ARB staff the impacts of this provision and potential enforcement alternatives.

Again, Evolution Markets appreciates the opportunity to comment on ARB's proposed rules for the implementation of AB 32. We appreciate your consideration of the comments above. If you wish to further discuss our recommendations, please feel free to contact John Battaglia or I at 415.963.9137.

Yours Sincerely,

//signed//

Lenny Hochschild
Managing Director, Global Carbon Markets

