

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

September 27, 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. 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 if purchased and banked early in the program before escalating marginal abatement costs. 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.

Although the latest round of proposed rule changes do not include additional early action protocols, ARB staff has indicated their intention to consider offset protocols relating to the replacement of high-bleed pneumatic valves and changes in agricultural processes. Evolution Markets applauds ARB's efforts to expand its early action protocols, and encourages the Board to adopt these protocols as expeditiously as possible. In addition, the ARB should publish a list of "priority" protocols for adoption by the Board next year.

Evolution Markets believes, however, that the potential volume from these protocols will continue to be insufficient to meet early demand for offsets. Therefore, Evolution Markets recommends ARB consider additional high-volume protocols for adoption in the early action program.

b. Conversion of Early Action Credits

In previous public comments, Evolution Markets advocated for regulatory changes to streamline the process for the conversion of early action offset credits (EACs) to ARB-issued offsets. Reducing the administrative burden and simplifying the conversion process will bring more offsets into the system in the early years of the program, where their cost containment benefits can be fully realized.

ARB's most recent round of proposed changes take important steps to effect this streamlining of the system. These include:

- 1.) **Holders of Allowances Permitted to Manage Conversion Process:** New language proposed by ARB will allow the holders of EACs, in addition to project operators and authorized project designees, to register projects for conversion. This provides credit buyers the ability to manage the conversion process without relying solely on the project owner, and Evolution Markets supports this rule change.
- 2.) **Streamlining of Desk Review:** The desk review of EACs submitted for issuance as ARB offsets has been streamlined by requiring the verifier simply review the verification statement for issuance under an approved early action protocol and eliminates a threshold of a 3% material misstatement as a trigger for full re-verification. Evolution Markets believed that the 3% level

would have created an unnecessarily large amount of reviews, which could impede the generation of an early supply of credits. The newly proposed process will maintain environmental integrity of the program, while ensuring a process for adequate offset supply.

- 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. 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. Evolution Markets has encouraged ARB in the past to create the accreditation program for project verifiers as soon as possible.

ARB has recognized this need, and staff has indicated that this program will begin in earnest at the conclusion of the rulemaking process. Evolution Markets continues to recommend 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 qualifying offsets 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.

B. Invalidation of Offset Credits

In Section 95985 of the proposed rule, ARB continues to make significant 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 the interest of constructive engagement on this important issue for the emerging California carbon market, Evolution Markets offers the following feedback on the rule changes recently proposed by ARB:

- 1.) **Reduction in Statute of Limitation:** ARB has proposed reducing the statute of limitations from five years to three years for ozone depleting substance (ODS) projects and from eight years to three years for livestock and forestry projects should these projects undergo a second verification within three years of credit issuance. This is a significant improvement, and Evolution Markets believes the emphasis on benefits of double verification is appropriate.

However, Evolution Markets suggests ARB eliminate the statute of limitation altogether once projects have completed a satisfactory second verification. Presumably, the second verification will be the mechanism for the discovery of any discrepancies that could cause an invalidation. Should the second verification validate the first, ARB should then eliminate that project from the risk of invalidation. The certainty such a change would provide is sure to encourage

investment in not only a second verification, which improves the integrity of the offsets program, but also offer sufficient incentive to stimulate investment in offset projects.

- 2.) **Tightened Criteria for Invalidation:** ARB has modified its proposal to permit invalidation only if the overstatement of reductions is more than 5% of the total issuance, the project activity was not in accordance with federal, state, or local environmental regulations, or the credits had already been used under another voluntary or mandatory program.

ARB also now has the ability to invalidate only the amount of credits actually overstated, and these invalidations will be imposed on all holders of credits from the project in question on a *pro rata* basis. Evolution Markets supports both of these changes and believes they will assist in encouraging investments in offset projects.

- 3.) **Extended Replacement Time for Invalidated Offsets:** Evolution Markets also supports ARB's suggested rule change to allow entities that have used invalidated offsets for compliance to take up to six months to replace these credits. Although Evolution Markets anticipates the actual amount of invalidated offsets to be small, providing this flexibility to compliance entities will protect against market disruptions that could have an adverse impact on credit prices and raise the overall costs of compliance.

II. Trading

Throughout the rulemaking process, Evolution Markets has commented on provisions contained within Section 95921 on "Conduct of Trade". We believe elements of this section provide an important foundation for California's carbon trading market. The market exists to offer entities the flexibility to find the lowest cost means of compliance with ambitious greenhouse gas reduction targets. Should rules governing trading activity unnecessarily constrain transactions or provide insufficient oversight, the market cannot effectively provide this important function.

ARB continues to propose a series of changes to this section, which Evolution Markets believes improves the language. For instance, Evolution Markets supports changes to this section that clarify ARB's authority to approve and oversee "transfers" of compliance entities, rather than the underlying transactions. ARB correctly understands that the carbon market is likely to evolve to include a variety of transaction structures that allow entities to manage risk and achieve low-cost compliance. Monitoring all these transactions is difficult, at best. Effecting regulatory oversight at the level of transfer is the proper role for ARB.

Provisions in Section 95921 also allow the ARB Executive Officer to review requests for transfers to ensure they meet basic criteria for reporting and adherence to holding limit regulations. As an important proposed change, ARB suggests building in a "cure period" that offers an element of flexibility.

Deficient transfer requests will be given three days to resubmit the request before transfers are executed. Transfer requests that are deemed deficient after transfer occurs will be given five days to resubmit the request, or the transfer will be reversed. Previously, ARB only had the authority to reverse trades, which would have forced entities to automatically unwind trades in the event of a deficiency.

While the “cure period” is a noted improvement, Evolution Markets still has strong concerns with the ability of the Executive Officer to reverse a transfer of compliance instruments. 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.

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.

Lastly, ARB’s transfer reversal authority could result in opportunities for market participants to game the cap-and-trade system. Entities that have either filed a deficient transfer request or have surpassed their holding limit may well welcome the ability of ARB to reverse a transfer, particularly if the trade underlying the transfer is out of the money at that given time.

Therefore, Evolution Markets supports the introduction of a “cure period” and believes the proposed three or five day period is sufficient. Evolution Markets encourages ARB to eliminate the authorization to reverse of trades, and instead institute a penalty for non-compliance should the entity not remedy the deficient transfer request in the allotted time.

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

