Clerk of the Board
California Air Resources Board
1001 I Street, Sacramento, California 95814
Submitted to: http://www.arb.ca.gov/lispub/comm/bclist.php

4 April 2014

IETA COMMENTS ON CALIFORNIA AIR RESOURCES BOARD'S PROPOSED 15-DAY MODIFICATIONS TO THE CAP-AND-TRADE REGULATION, THE MINE METHANE CAPTURE OFFSET PROTOCOL, AND ASSOCIATED MATERIAL

The International Emissions Trading Association (IETA) appreciates this opportunity to provide comments in response to the California Air Resources Board's (ARB) proposed 15-day modifications to the cap-and-trade regulation, the mine methane capture offset protocol, and associated support documents. We thank you for considering IETA's perspectives.

OVERVIEW

IETA's comments are structured around the following topics:

1. **Compliance Unit Surrender Order;**
2. **Registration with ARB;**
3. **Transaction Reporting Requirements;**
4. **Limited Exemption;**
5. **Cost Containment;**
6. **Mine Methane Capture Offset Protocol; and**
7. **Requirements for Offset Projects & Verification Bodies.**

1. COMPLIANCE UNIT SURRENDER ORDER

Section 95856 of the proposed amendments continues to specify an automatic compliance unit surrender order in which the Executive Officer retires compliance units from a compliance entity's account in both annual and triennial compliance years. While the September 2013 proposed amendments removed annual compliance surrender obligations, the proposed 15-day amendments re-instate those annual compliance obligations.

Regardless of whether there exists, or doesn't exist, an annual compliance surrender obligation, IETA would like to re-state for the record that individual entities should, themselves, be given the flexibility to indicate which compliance units they would like to surrender. We appreciate the need to provide a default surrender order in case an entity fails to indicate its own surrender order, but this default order should not supersede an entity's preference, if indicated. We understand that the Compliance Instrument Tracking System Service (CITSS) currently does not have the functionality to allow entities to indicate their own retirement order preference, but our membership contends that the benefits of implementing such functionality outweigh the cost.

Automatic Surrender Order Exacerbates Holding Limits Issues

Due to the holding limit as currently written, a large final emitter (LFE) has significantly less flexibility to keep allowances in its holding account than other regulated entities, and often must

store a significant number of allowances in its compliance account. Where smaller entities may hold onto allowances in their holding account right up until the compliance deadline, an LFE must keep allowances to cover its compliance obligation in its compliance account to navigate the holding limit. The pre-determined compliance unit retirement order that ARB proposes presents just another additional challenge to navigate for account representatives, who will face the additional challenge of balancing allowances and offsets in their compliance accounts.

Tax and Accounting Considerations

In previous rounds of stakeholder comments, IETA has provided detail on how the proposed automatic compliance unit surrender order may prove problematic in dealing with important accounting concerns. We repeat those concerns here.

Consider the U.S. Environmental Protection Agency's (EPA) Acid Rain Program in determining the importance of an entity's ability to choose which compliance units it retires in light of tax implications. In the Acid Rain Program, an entity has the option to choose to retire specific allowances based on their tax basis (this is often referred to as "specific identification" by the accountants).

For tax purposes the basis of a freely allocated allowance is usually zero. That contrasts with a purchased allowance, where for tax purposes the basis would be the purchase price. An entity can then choose to retire an allowance based on its tax basis. In the Acid Rain Program, since SO2 allowances are treated as a capital asset, a company could choose allowances based on how it would impact its capital gains posture for a given year.

According to a Journal of Accountancy report, approximately three quarters of companies value freely allocated allowances at zero, and purchased allowances at cost[1]. With this in mind, entities may want to choose to retire compliance units in a different order than is proposed by ARB. Different entities will have different financial drivers depending on their industry, financial situation, accounting policy, etc. – so while one company may wish to retire freely allocated allowances first, another may wish to do the opposite. Similarly, one company may wish to retire earlier vintages first, and another may wish to retire later vintages first. Consider the following example:

A company in California is expected to emit 100 tons of GHGs per year in 2013 and 2014, and ARB allocates 80 allowances/year for free (i.e. 80 vintage 2013 allowances and 80 vintage 2014 allowances) leaving a shortfall of 20 tons/year that must be bought in the marketplace.

Assume that this company is concerned about rising costs, so it buys 40 tons of vintage 2013 allowances (the most liquid contract) in the marketplace at $15/ton to hedge its price risk. The regulation allows the company to use vintage 2013 allowances for compliance with 2013 or 2014 emissions.

Assume, now, that for whatever reason (perhaps production was down), that company only actually emitted 90 tons in 2013 and 90 tons in 2014. This leaves it with 20 surplus allowances, which it banks for 2015.

[1] Journal of Accountancy Access here: http://www.journalofaccountancy.com/Issues/2009/Jul/20081312

The regulation says that ARB will retire allowances in a specific order, starting with the earliest vintages (i.e. all vintage 2013s will be retired first). So in the company's registry account, it is left with 20 vintage 2014 allowances. Since all of these were allocated for free, this would be valued at zero on the company's balance sheet.

However, depending on the company's inventory/accounting policy, that company may actually prefer to retire all freely allocated allowances first (including all vintage 2014s), leaving them with 20 vintage 2013 allowances instead (which they value at cost).

As this example points out, there are important accounting considerations that make it necessary that an entity has the option to choose its own compliance unit surrender order depending on different circumstances. IETA strongly encourages ARB to provide this capability within CITSS.

Annual 8 Percent Offset Usage Limit

In the January 2014 discussion draft, ARB specifically asked stakeholders whether the offset usage limit should apply on annual compliance years, or only the triennial compliance years. The subsequent 15-day proposed amendments have instituted the 8% annual limit

In IETA's February 2014 comments, we recommended that there should be no 8 percent usage limit on offsets in annual compliance surrender years, and we continue to advocate this position. If an entity over-surrenders offsets in its annual compliance years to the extent that it is already beyond its 8 percent limit by the triennial compliance deadline, ARB should devise means to allow those over-surrendered offset credits to retain value – whether that be through returning the units to the compliance entity, allowing those excess units to be applied towards the next compliance period, or some other means.

2. REGISTRATION WITH ARB

A. Section 95830(c)(1)(H): Identification of Corporate Associations

Section 95830 of proposed amendments retains a proposed change within the program that requires identification of all other entities with whom the entity has a corporate association, direct corporate association, or indirect corporate association. In the currently standing regulation, these association disclosures are only required for associated entities registered pursuant to the program. The new proposal significantly expands the requirement for identification to associations far beyond the reach of the California program.

A number of IETA's members are large corporations with many corporate associations across the globe. For some IETA members, the number is in excess of 1000 affiliates and subsidiaries. The proposed requirement as outlined in the proposed amendments would be very difficult to maintain as hundreds of these associations are constantly changing, making submitted lists obsolete soon after submittal to ARB. Given the magnitude of what is being required, IETA wonders if ARB itself would view it as worthwhile to undertake the management of such a large influx of information.

Further, IETA is unsure why it is of interest to ARB to have record of corporate associations for entities not registered or otherwise involved in the cap-and-trade program. Unless there is some rationale that IETA is not aware of, we recommend reverting to the language as written in the current regulation.

B. Section 95830(c)(1)(I): Identification of Persons with Access to Information

IETA appreciates the modifications made to this section as written in the proposed amendments. The new language appears to provide a more specific definition of those employees that should be required to provide contact information for program registration, which is much more manageable to maintain. However, additional clarity is required regarding the term "holdings".

IETA understands the term "holdings" to refer to the number of compliance instruments an entity has in each of its individual ARB account balances in CITSS. To confirm this interpretation, and to facilitate compliance with the staff reporting requirement, the "holdings" term should be defined.

C. Section 95830(c)(7): Registration of Account Viewing Agents

The added language in section 95830(c)(7) that requires account viewing agents to provide registration details to ARB seems unnecessary and onerous for individuals whose account access is already limited. By definition, an account viewing agent cannot transact, and can only review an account status. The level of detail required for registration in ARB's proposed amendments is not commensurate with an account viewing agent's responsibility.

Consider, also, that it may be common practice for multi-national companies to employ non-US residents as account viewing agents – employees who would not have US bank accounts.

D. Section 95830(f): Disproportionate Penalties for Failure to Update Registration Information

IETA appreciates modifications within the proposed amendments in Section 95830(f)(1) and (3) to extend the period of time from 10 to 30 days that an entity has to make changes to its registration information as listed in 95830(c).

However, the language in 95921(g)(3) that may force an entity that fails to update its registration information within 30 days to sell or voluntarily retire all of the compliance units in its holding account is a disproportionately harsh penalty for what could be a reasonable oversight in failing to update registration details.

IETA recommends language be adjusted to clarify that only in the most extreme cases of negligence resulting in failure to update an entity's registration information, should an entity be forced to sell all units in its holding account. As currently written, the language in 95921(g)(3) provides the Executive Officer too much subjectivity, and presents an extreme risk to compliance entities.

E. Section 95834(c)(2): Resubmittal of Know-Your-Customer Requirements

Section 95834(c)(2) continues to propose that the Executive Officer *may* re-verify all documents associated with Know-Your Customer (KYC) requirements every two years, which could require submittal of updated KYC registration documents from an individual registered in the program. Added clarity on why re-verification of KYC documents might be necessary would be appreciated, particularly as re-submittal of KYC documents may be quite onerous (bank account information, addresses, photo identification). Current regulatory language that requires re-submittal of information simply in the event that an individual's registration details change is preferable for IETA members.

F. Section 95912(d): Registration in Auctions

While IETA appreciates the changes to Section 95912(d)(5), the language contained in the proposed amendments could still bar an entity from participating in an auction if there are changes to information provided in an entity's auction application 30 days before an auction. The activities described in the auction application cover a range of activities that a company may need to perform in the course of its business and simply cannot remain static in order to participate in the cap-and-trade auctions.

ARB staff acknowledges that Section 95912(d) is intended to facilitate effective settlement of the auctions and support market monitoring, and is not intended to be overly burdensome. To accomplish ARB's objectives, Section 95912(d) should be further tailored to only restrict changes to the entity's corporate identity set forth in Section 95912(d)(4)(A). Otherwise, the provision unnecessarily jeopardizes an entity's auction participation for activities associated with its normal business operations or beyond its reasonable control.

G. Section 95912(d)(4)(E): Attestations for Registration in Auctions

IETA appreciates the change in the proposed amendments to the provision in section 95912(d)(4)(E) that removes language requiring that an entity participating in an auction (including all associated entities) submit an attestation indicating that it has never been subject to any previous or ongoing investigation regarding "any alleged violation of any rule, regulation, or law associated with any commodity, securities, or financial market, including a change in the status of an ongoing investigation". The new language requiring instead disclosure of the existence of any ongoing or previous investigation is much more reasonable.

However, IETA would like to propose ARB include knowledge and materiality qualifiers to this section as well to ensure companies (particularly large companies) are able to conduct appropriate diligence and provide the required information in a timely fashion. For example, a utility would not want to violate the cap-and-trade regulation due to a failure to report a minor administrative violation of a CFTC rule connected to its energy purchases, which would likely be unrelated to the utility's cap-and-trade activities.

H. Section 95923: Definition of Cap-and-Trade Consultant or Advisor

IETA objects to the inclusion of legal services within the new disclosure requirement for cap-and-trade consultants and advisors in section 95923. Confidentiality is fundamental to the practice of law, and our members have a legitimate expectation that their relationships with their outside counsel will remain confidential – including, at times, the existence of such a relationship itself. Disclosure of these relationships could operate to waive attorney-client privilege in certain cases, which could create a disincentive to retaining counsel in the first place and hinder program participants' ability and efforts to seek a better understanding of and comply with the program.

Moreover, we do not believe that disclosure is necessary to ensure the integrity of the cap-and-trade program. Attorneys are independently subject to existing legal and ethical rules – rules that prohibit them from advising their clients to disobey the law and require them to maintain client confidences. These existing rules already operate to prevent lawyers from engaging in activities that could compromise the cap-and-trade market.

As a practical solution to this issue, ARB should exempt persons or entities providing legal services from the definition of "Cap-and-Trade Consultant or Advisor" in the proposed Section 95923.

3. TRANSACTION REPORTING REQUIREMENTS

A. Definitions

IETA's previous stakeholder comments raised concerns with the definitions of "futures" and "spot" contracts, and extending from those definitions, the reporting requirement to distinguish between futures and spot contracts in section 95921(b)(5)(C). The proposed amendments eliminate "futures" and "spot" contract language completely, thereby assuaging IETA's concerns.

Further, IETA very much appreciates staff adjusting the "Over-The-Counter" definition to: "the trading of carbon compliance instruments, contracts, or other instruments not executed or entered for clearing on any exchange."

B. Section 95921(b)(1)(B): Counterparty Account Representative Confirmation

IETA supports the change originally appearing in the discussion draft section 95921(b)(1)(B) removing the requirement that the seller of units in a transaction must need to know the "… identification of a primary account representative or alternative account representative for the destination account confirming the transfer request, if confirmation of the transfer request is required."

C. Section 95921(a)(5): Pre-Existing Transaction Agreements

IETA supports the change in the proposed amendments section 95921(a)(4) that provides added clarity that written or recorded oral agreement may constitute a transaction agreement.

D. Section 95921(b)(3)(B): Settlement Dates

IETA appreciates the addition in the proposed amendments allowing for the listing of an expected settlement date in transactions where the settlement date is not fixed and may be subject to floating dates or dates triggered by other events. Additional clarity would be useful pointing out that if an expected settlement date happens to change, ARB will not hold the reporting entity liable.

E. Section 95921(b)(4)(B): Transaction Agreement Termination Dates

IETA supports the changes allowing for an expected termination date, however the use of this term is inconsistent within the proposed amendments. The description of what should be entered as the Expected Termination Date set forth in Section 95921(b)(3) contradict the definition of Expected Termination Date. In particular, the definition set forth in Section 95802 carves out contingencies, but 95921(b)(3)(B) inserts contingencies. To harmonize Section 95921(b)(3)(B) with the definition, IETA suggests the following revision:

> 95921(b)(3)(B) <u>Expected Termination Date of the transaction agreement. If completion of the transfer request process is the last term of the transaction agreement to be completed, the date the transfer request is submitted should be entered as the Expected Termination</u>

Date. If there are financial, ~~**contingency,**~~ or other terms **excluding contingencies,** to be settled after the transfer request is completed, the date those terms are expected to be settled should be entered as the Expected Termination Date. If the transaction agreement does not specify a date for the settlement of financial, contingency, or other terms that would be completed after the transfer request is completed, the entity may enter the Expected Termination Date as "Not Specified."

Similarly to the settlement date issue above, IETA also requests confirmation that if an expected termination date happens to change, that ARB will not hold the reporting entity liable.

F. Section 95921(b)(4)(D): Identification of Other Products

IETA appreciates the clarification within section 95921(b)(4)(D) that adjusts the reporting requirement to simply state whether a transaction agreement involves transfers for other products, and not to identify those other products.

4. LIMITED EXEMPTION

IETA appreciates the additional clarity provided in Section 95920(d)(2)(G) within the proposed amendments as compared to January 2014's discussion draft.

5. COST CONTAINMENT

As stated in IETA's previous January 2014 submission, IETA supports ARB's proposal (as an initial first step) to make available 10% of future allowance budgets, as needed, at reserve sales once per year starting in 2015 at the highest price tier of the Allowance Price Containment Reserve (APCR).

This provision may provide some short-term relief in the case that prices rise unexpectedly. However, IETA does not believe that this provision adequately satisfies the Board Directive to prevent allowance prices from rising beyond the APCR, particularly in the case of an extended period of high demand due to unforeseen market dynamics or economic imbalances. Ultimately, it is in ARB and IETA's interest alike to ensure that prices do not rise so high that the Governor feels pressure to step in and exercise his/her right to suspend the cap-and-trade program.

IETA encourages ARB to re-visit the proposals originally discussed at the 25 June 2013 Public Workshop (including those by ARB, EMAC, and the Joint Utilities Group[2]), which explored a number of innovative options that would serve to keep prices below the highest-tier APCR price, while at the same time maintain environmental integrity.

In particular, IETA considers two options presented at the 25 June 2013 workshop to be worth further consideration:

Offsets as Cost Containment

Expanding offset supply would be an effective means of containing the cost of the cap-and-trade program, while also ensuring environmental integrity of the program.

[2] Joint Utilities Group Presentation: http://www.arb.ca.gov/cc/capandtrade/meetings/062513/industry-present.pdf

Additional low-cost compliance options could be introduced into the system through offsets in a variety of ways, but first and foremost is ensuring that offset supply meets demand. That can be done through the timely development and adoption of additional compliance offset protocols such as the Mine Methane Capture protocol (more on this below).

Aside from the adoption of additional protocols, two relatively simple options to increase the effectiveness of offsets as a cost containment mechanism are: 1) expand entity compliance limits beyond 8%; or 2) allow entities to carry over unused offset limits from one compliance period to the next.

Sourcing Allowances from Third Party Greenhouse Gas Reduction Programs

If faced with an extreme case where keeping prices below the highest tier of the APCR was proving difficult, ARB could have a provision ready to kick in that allowed the creation of additional allowances to be sold at the highest tier price, providing crucial cost relief.

In order to maintain environmental integrity, the state of California could use revenue from the sale of these additional allowances to buy and then retire quantifiable and certified allowances from third party greenhouse gas reduction programs (such as the Regional Greenhouse Gas Initiative (RGGI)). Meaning that for each additional California Carbon Allowance (CCA) that ARB created and sold, a corresponding RGGI allowance would be retired. California could even choose to implement a quota system where for each additional CCA it created it would retire (for example) three RGGI allowances.

Not only would such a system provide cost relief and maintain environmental integrity, it would also serve to indirectly link its market to other markets – a goal outlined in AB32 to build regional and international markets. IETA would be pleased to work with ARB moving forward in this pursuit.

6. MINE METHANE CAPTURE OFFSET PROTOCOL

IETA strongly supports the proposed compliance offset protocol for mine methane capture (MMC) projects. Offset credits represent a crucial cost containment mechanism to help the California cap-and-trade program achieve GHG emission reductions in an economically efficient manner. IETA encourages officials to approve and make effective the protocol as soon as possible.

The additional economic analysis provided by ARB staff that assesses the MMC protocol's potential affect on future mining projects is a welcome addition to the rule-making record. The report provides further concrete rationale in favour of the approval of the protocol, and should serve to alleviate the concerns of critics that claim the protocol could incentivize increased coal mining.

We also support the expansion of the definition of "Offset Project Developer" within the proposed MMC protocol to include not just the mine operator but also the entity that owns or leases the equipment used to capture or destroy mine methane (section 3.3(d)(2)).

Generally, IETA supports ARB's efforts to develop new protocols that can provide offset credits to supply the market. In addition, we encourage ARB to update and expand existing protocols that can increase supply of already-proven, high-quality offset credits in the near-term.

7. REQUIREMENTS FOR OFFSET PROJECTS & VERIFICATION BODIES

A. Section 95973(b): Offset Project Regulatory Compliance

Section 95973(b) can be interpreted as treating an entire Reporting Period as ineligible for offset credits if there is any violation, even if the violation was recorded for a limited time within a longer Reporting Period. There may be cases of non-compliance that do not span an entire Reporting Period and the instance of non-compliance has no impact on the other activities during the Reporting Period. We suggest that ARB explicitly states that it will retain the discretion to not issue offset credits only for specific times of non-compliance and amend the language as follows:

> "If the offset project is not in compliance with regulatory requirements directly applicable to the offset project during a part of the Reporting Period, the Offset Project Operator should be able to subtract any emission reductions that were generated during the time of non-compliance from the project's total emission reductions. ARB will issue offset credits only for the activities completed during the Reporting Period when the project was in compliance."

B. Section 95977.1(a)(1): Rotation of Verification Bodies for ODS Projects

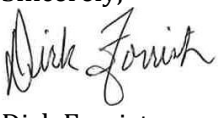
Section 95977.1(a)(1) specifies that after six consecutive projects, project developers must use another verification body for a minimum of three projects. However, the Offset Project Operator (OPO) can only use the previous verification body once verification services have been completed for the three projects. IETA supports enforced rotation, however, for Ozone Depleting Substance (ODS) projects, the proposed rotation frequency is not practical given the limited number of approved verification bodies and will limit the ability of project developers to generate offset credits. IETA recommends that at minimum, ARB clarify that for ODS projects, the requirement for verification body rotation for generation of ARBOC(8) offsets (credits with 8-year invalidation risk) and for conversion of ARBOC(8) credits to ARBOC(3) credits are independent of one another.

CONCLUDING REMARKS

IETA appreciates the opportunity to record our comments related to ARB's proposed 15-day modifications to the cap-and-trade regulation, the mine methane capture offset protocol, and associated support documents. Not only is IETA intent on helping to support a fully-functional California carbon market, we are also committed to helping achieve the goals of AB 32 to develop inter-jurisdictional and regional linked markets in order to realize environmental goals in an economically efficient manner.

If you have any questions, or further clarification is required, please do not hesitate to contact Robin Fraser (fraser@ieta.org).

Sincerely,



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